Subchapter K Regulations

Sec. 1.701-1 Partners, not partnership, subject to tax.

Partners are liable for income tax only in their separate capacities. Partnerships as such are not subject to the income tax imposed by Subtitle A but are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms "partner" and "partnership", see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

Sec. 1.701-2 Anti-abuse rule.

(a) Intent of subchapter K.

Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements –

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, PROPER REFLECTION OF INCOME). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) EXAMPLE 6 of this section (relating to the value-equals-basis rule in section 1.704-1(b)(2)(iii)(c)), paragraph (d) EXAMPLE 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) EXAMPLES 10 AND 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, sections 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).
(b) Application of subchapter K rules.

The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (INTENT OF SUBCHAPTER K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K --

(1) The purported partnership should be disregarded in whole or in part, and the partnership’s assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

(2) One or more of the purported partners of the partnership should not be treated as a partner;

(3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership’s or the partner’s income;

(4) The partnership’s items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should otherwise be adjusted or modified.

(c) Facts and circumstances analysis; factors.

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners’ aggregate federal tax liability is substantially less than had the partners owned the partnership’s assets and conducted the partnership’s activities directly;

(2) The present value of the partners’ aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions
that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of sections 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

(d) Examples.

The following examples illustrate the principles of paragraphs (a), (b), and (c) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

**Example 1.** Choice of entity; avoidance of entity-level tax; use of partnership consistent with the intent of subchapter K.

(i) A and B form limited partnership PRS to conduct a bona fide business. A, the corporate general partner, has a 1% partnership interest. B, the individual limited partner, has a 99% interest. PRS is properly classified as a partnership under
sections 301.7701-2 and 301.7701-3. A and B chose limited partnership form as a means to provide B with limited liability without subjecting the income from the business operations to an entity-level tax.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. Although B has retained, indirectly, substantially all of the benefits and burdens of ownership of the money or property B contributed to PRS (see paragraph (c)(6) of this section), the decision to organize and conduct business through PRS under these circumstances is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 2. Choice of entity; avoidance of subchapter S shareholder requirements; use of partnership consistent with the intent of subchapter K. (i) A and B form partnership PRS to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a nonresident alien. PRS is properly classified as a partnership under sections 301.7701-2 and 301.7701-3. Because section 1361(b) prohibits B from being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance (inasmuch as application of the substance over form doctrine arguably could result in B being treated as a shareholder of A, thereby invalidating A’s subchapter S election), the facts indicate otherwise. The shareholders of A are subject to tax on their pro rata shares of A’s income (see section 1361 et. seq.), and B is subject to tax on B’s distributive share of partnership income (see sections 871 and 875). Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 3. Choice of entity; avoidance of more restrictive foreign tax credit limitation; use of partnership consistent with the intent of subchapter K. (i) X, a domestic corporation, and Y, a foreign corporation, form partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each owns a 50% interest in PRS. PRS is properly classified as a partnership under sections 301.7701-2 and 301.7701-3. PRS pays income taxes to Country A. X and Y chose partnership form to enable X to qualify for a direct foreign tax credit under section 901, with look-through treatment under section 1.904-5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under section 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to section 904(d)(1)(E) and section 1.904-4(g), the dividends and associated taxes
would be subject to a separate foreign tax credit limitation for dividends from PRS, a noncontrolled section 902 corporation.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 4. Choice of entity; avoidance of gain recognition under sections 351(e) and 357(c); use of partnership consistent with the intent of subchapter K.

(i) X, ABC, and DEF form limited partnership PRS to conduct a bona fide real estate management business. PRS is properly classified as a partnership under sections 301.7701-2 and 301.7701-3. X, the general partner, is a newly formed corporation that elects to be treated as a real estate investment trust as defined in section 856. X offers its stock to the public and contributes substantially all of the proceeds from the public offering to PRS. ABC and DEF, the limited partners, are existing partnerships with substantial real estate holdings. ABC and DEF contribute all of their real property assets to PRS, subject to liabilities that exceed their respective aggregate bases in the real property contributed, and terminate under section 708(b)(1)(A). In addition, some of the former partners of ABC and DEF each have the right, beginning two years after the formation of PRS, to require the redemption of their limited partnership interests in PRS in exchange for cash or X stock (at X's option) equal to the fair market value of their respective interests in PRS at the time of the redemption. These partners are not compelled, as a legal or practical matter, to exercise their exchange rights at any time. X, ABC, and DEF chose to form a partnership rather than have ABC and DEF invest directly in X to avoid recognition of gain under sections 351(e) and 357(c). Because PRS would not be treated as an investment company within the meaning of section 351(e) if PRS were incorporated (so long as it did not elect under section 856), section 721(a) applies to the contribution of the real property to PRS. See section 721(b).

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS, thereby avoiding the tax consequences that would have resulted from contributing the existing partnerships' real estate assets to X (by applying the rules of sections 721, 731, and 752 in lieu of the rules of sections 351(e) and 357(c)), is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the transaction should not be respected because it does not reflect its substance (inasmuch as the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the transaction were integrated and treated as a contribution of the encumbered assets by ABC and DEF directly to X, see paragraph (c)(2) of this section), the facts indicate otherwise. For example, the right of some of the former ABC and DEF partners after two years to
exchange their PRS interests for cash or X stock (at X's option) equal to the fair market value of their PRS interest at that time would not require that right to be considered as exercised prior to its actual exercise. Moreover, X may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes. Thus, although it may be likely that some or all of the partners with the right to do so will, at some point, exercise their exchange rights, and thereby receive either cash or X stock, the form of the transaction as a separate partnership and real estate investment trust is respected under substance over form principles (see paragraph (a)(2) of this section). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 5. Special allocations; dividends received deductions; use of partnership consistent with the intent of subchapter K.

(i) Corporations X and Y contribute equal amounts to PRS, a bona fide partnership formed to make joint investments. PRS pays $100x for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of $6x. PRS specially allocates the dividend income on the Z stock to X to the extent of the London Inter-Bank Offered Rate (LIBOR) on the record date, applied to X’s contribution of $50x, and allocates the remainder of the dividend income to Y. All other items of partnership income and loss are allocated equally between X and Y. The allocations under the partnership agreement have substantial economic effect within the meaning of section 1.704-1(b)(2). In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in the Z common stock and to allocate the dividend income from the stock to provide X with a floating-rate return based on LIBOR, while permitting X and Y to claim the dividends received deduction under section 243 on the dividends allocated to each of them.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Section 704(b) and section 1.704-1(b)(2) permit income realized by the partnership to be allocated validly to the partners separate from the partners’ respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Section 704(e)(2) is not applicable to the facts of this example (otherwise, the allocations would be required to be proportionate to the partners’ ownership of contributed capital). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 6. Special allocations; nonrecourse financing; low-income housing credit; use of partnership consistent with the intent of subchapter K.

(i) A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, form general partnership PRS to own and operate a building that qualifies for the low-income housing credit provided by section 42. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement provides for special allocations of income
and deductions, including the allocation of all depreciation deductions attributable to
the building to A and B equally in a manner that is reasonably consistent with
allocations that have substantial economic effect of some other significant
partnership item attributable to the building. The section 42 credits are allocated to A
and B in accordance with the allocation of depreciation deductions. PRS's
allocations comply with all applicable regulations, including the requirements of
sections 1.704-1(b)(2)(ii) (pertaining to economic effect) and 1.704-2(e)
(requirements for allocations of nonrecourse deductions). The nonrecourse
indebtedness is validly allocated to the partners under the rules of section 1.752-3,
thereby increasing the basis of the partners' respective partnership interests. The
basis increase created by the nonrecourse indebtedness enables A and B to deduct
their distributive share of losses from the partnership (subject to all other applicable
limitations under the Internal Revenue Code) against their nonpartnership income
and to apply the credits against their tax liability.

(ii) At a time when the depreciation deductions attributable to the building are not
treated as nonrecourse deductions under section 1.704-2(c) (because there is no
net increase in partnership minimum gain during the year), the special allocation of
depreciation deductions to A and B has substantial economic effect because of the
value-equals-basis safe harbor contained in section 1.704-1(b)(2)(iii)(c) and the fact
that A and B would bear the economic burden of any decline in the value of the
building (to the extent of the partnership's investment in the building),
notwithstanding that A and B believe it is unlikely that the building will decline in
value (and, accordingly, they anticipate significant timing benefits through the special
allocation). Moreover, in later years, when the depreciation deductions attributable
to the building are treated as nonrecourse deductions under section 1.704-2(c), the
special allocation of depreciation deductions to A and B is considered to be
consistent with the partners' interests in the partnership under section 1.704-2(e).

(iii) Subchapter K is intended to permit taxpayers to conduct joint business activity
through a flexible economic arrangement without incurring an entity-level tax. See
paragraph (a) of this section. The decision to organize and conduct business
through PRS is consistent with this intent. In addition, on these facts, the
requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied.
Section 704(b), section 1.704-1(b)(2), and section 1.704-2(e) allow partnership items
of income, gain, loss, deduction, and credit to be allocated validly to the partners
separate from the partners' respective ownership of the capital to which the
allocations relate, provided that the allocations satisfy both the literal requirements of
the statute and regulations and the purpose of those provisions (see paragraph
(c)(5) of this section). Moreover, the application of the value-equals-basis safe
harbor and the provisions of section 1.704-2(e) with respect to the allocations to A
and B, and the tax results of the application of those provisions, taking into account
all the facts and circumstances, are clearly contemplated. Accordingly, even if the
allocations would not otherwise be considered to satisfy the proper reflection of
income standard in paragraph (a)(3) of this section, that requirement will be treated
as satisfied under these facts. Thus, even though the partners' aggregate federal tax
liability may be substantially less than had the partners owned the partnership's
assets directly (due to X's inability to use its allocable share of the partnership's
losses and credits) (see paragraph (c)(1) of this section), the transaction is not
inconsistent with the intent of subchapter K. The Commissioner therefore cannot
invoke paragraph (b) of this section to recast the transaction.
Example 7. Partner with nominal interest; temporary partner; use of partnership not consistent with the intent of subchapter K.

(i) Pursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a substantial amount of income, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing $9,000x, $990x, and $10x, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for $10,000x and validly leases the equipment offshore for a term representing most of its projected useful life. Shortly thereafter, PRS sells its rights to receive income under the lease to a third party for $9,000x, and allocates the resulting $9,000x of income $8,100x to X, $891x to Y, and $9x to Z. PRS thereafter makes a distribution of $9,000x to X in complete liquidation of its interest. Under section 1.704-1(b)(2)(iv)(f), PRS restates the partners' capital accounts immediately before making the liquidating distribution to X to reflect its assets consisting of the offshore equipment worth $1,000x and $9,000x in cash. Thus, because the capital accounts immediately before the distribution reflect assets of $19,000x (that is, the initial capital contributions of $10,000x plus the $9,000x of income realized from the sale of the lease), PRS allocates a $9,000x book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of $9,000x, $990x, and $10x, respectively. Thereafter, PRS purchases real property by borrowing the $8,000x purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from $1,881x and $19x, to $9,801x and $99x, respectively (reflecting Y's and Z's adjusted interests in the partnership of 99% and 1%, respectively). PRS subsequently sells the offshore equipment, subject to the lease, for $1,000x and allocates the $9,000x tax loss $8,910x to Y and $90x to Z. Y's and Z's bases in their partnership interests are therefore reduced to $891x and $9x, respectively.

(ii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), (3), and (5) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section) and does not properly reflect the income of Y (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or the validity of the allocations under section 1.704-1(b)(2) (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 8. Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K.

(i) A owns land with a basis of $100x and a fair market value of $60x. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the
duplication, for a substantial period of time, of the tax benefit of A’s built-in loss in the land. To effect this plan, A, C (A’s brother), and W (C’s wife) form partnership PRS, to which A contributes the land, and C and W each contribute $30x. All partnership items are shared in proportion to the partners’ respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership’s assets have not materially changed, PRS agrees with A to liquidate A’s interest in exchange for the investment asset held by PRS. Under section 732(b), A’s basis in the asset distributed equals $100x, A’s basis in A’s partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a $40x loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS’s basis in the land contributed by A remains $100x. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60x (its fair market value). Thus, PRS recognizes a $40x loss on the sale, which is allocated equally between C and W. C’s and W’s bases in their partnership interests are reduced to $10x each pursuant to section 705. Their respective interests are worth $30x each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20x of gain. However, PRS’s continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A’s built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners’ tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners’ income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners’ aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 9. Absence of section 754 election; use of partnership consistent with the intent of subchapter K.
PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of $100x, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A and the managing general partner, P. P and A agree to distribute to A $100x worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20x. Upon distribution, A's aggregate basis in the securities is $100x under section 732(b). PRS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the $80x of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electively of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 election were not made, basis distortions may result. Taking into account all the facts and
circumstances of the transaction, the electively of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 10. Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K.

(i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100x, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60x and a basis to PRS of $40x, and related equipment with two years of cost recovery remaining and a value and basis to PRS of $40x. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732(b) and (c), A's $100x basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or $50x to the nondepreciable asset and $50x to the equipment. Thus, A will have a $10x built-in gain in the nondepreciable asset ($60x value less $50x basis) and a $10x built-in loss in the equipment ($50x basis less $40x value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732(b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a
depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 11. Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K.

(i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of $95x and a basis of $5x. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100x to PRS for an interest therein. Subsequently (at a time when the value of the partnership’s assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of $5x. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732(b) and (c), X's $100x basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or $50x each. Thereafter, X plans to sell the second asset for its value of $5x, recognizing a loss of $45x. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732(b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.

(ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute’s simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained
in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

(e) Abuse of entity treatment.

(1) General rule.

The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.

(2) Clearly contemplated entity treatment.

Paragraph (e)(1) of this section does not apply to the extent that --

(i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and

(ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

(f) Examples.

The following examples illustrate the principles of paragraph (e) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

**Example 1.** Aggregate treatment of partnership appropriate to carry out purpose of section 163(e)(5).

(i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS issues certain high yield discount obligations to an unrelated third party. Section 163(e)(5) defers (and in certain circumstances disallows) the interest deductions on this type of obligation if issued by a corporation. PRS, X, and Y take
the position that, because PRS is a partnership and not a corporation, section 163(e)(5) is not applicable.

(ii) Section 163(e)(5) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 163(e)(5) is to limit corporate-level interest deductions on certain obligations. The treatment of PRS as an entity could result in a partnership with corporate partners issuing those obligations and thereby circumventing the purpose of section 163(e)(5), because the corporate partner would deduct its distributive share of the interest on obligations that would have been deferred until paid or disallowed had the corporation issued its share of the obligation directly. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 163(e)(5) (regardless of whether any party had a tax avoidance purpose in having PRS issue the obligation). Each partner of PRS will therefore be treated as issuing its share of the obligations for purposes of determining the deductibility of its distributive share of any interest on the obligations. See also section 163(i)(5)(B).

Example 2. Aggregate treatment of partnership appropriate to carry out purpose of section 1059.

(i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS purchases 50 shares of Corporation Z common stock. Six months later, Corporation Z announces an extraordinary dividend (within the meaning of section 1059). Section 1059(a) generally provides that if any corporation receives an extraordinary dividend with respect to any share of stock and the corporation has not held the stock for more than two years before the dividend announcement date, the basis in the stock held by the corporation is reduced by the nontaxed portion of the dividend. PRS, X, and Y take the position that section 1059(a) is not applicable because PRS is a partnership and not a corporation.

(ii) Section 1059(a) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 1059(a) is to limit the benefits of the dividends received deduction with respect to extraordinary dividends. The treatment of PRS as an entity could result in corporate partners in the partnership receiving dividends through partnerships in circumvention of the intent of section 1059. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 1059 (regardless of whether any party had a tax avoidance purpose in acquiring the Z stock through PRS). Each partner of PRS will therefore be treated as owning its share of the stock. Accordingly, PRS must make appropriate adjustments to the basis of the Corporation Z stock, and the partners must also make adjustments to the basis in their respective interests in PRS under section 705(a)(2)(B). See also section 1059(g)(1).

Example 3. Prescribed entity treatment of partnership; determination of CFC status clearly contemplated.

(i) X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS is properly classified as a partnership under sections 301.7701-2 and 301.7701-3. PRS
holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes under section 301.7701-2. Z conducts its business operations in Country A. By investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

(ii) Pursuant to sections 957(c) and 7701(a)(30), PRS is a United States person. Therefore, because it owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under section 951(b). Under section 957(a), Z is a controlled foreign corporation (CFC) because more than 50% of the voting power or value of its stock is owned by PRS. Consequently, under section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes paid or accrued by Z. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. X’s credit for foreign taxes paid or accrued by Z in that case would be subject to a separate foreign tax credit limitation for dividends from Z, a noncontrolled section 902 corporation. See section 904(d)(1)(E) and section 1.904-4(g).

(iii) Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC. The CFC rules prevent the deferral by U.S. shareholders of U.S. taxation of certain earnings of the CFC and reduce disparities that otherwise might occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly rather than indirectly through a CFC. The application of the look-through rules for foreign tax credit purposes is appropriately tied to CFC status. See sections 904(d)(2)(E) and 904(d)(3). This analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X’s foreign tax credit limitation.

(g) Effective date.

Paragraphs (a), (b), (c), and (d) of this section are effective for all transactions involving a partnership that occur on or after May 12, 1994. Paragraphs (e) and (f) of this section are effective for all transactions involving a partnership that occur on or after April 12, 1995.

(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 nonstatutory principles and other statutory and regulatory authorities to
challenge transactions. This section does not limit the applicability of those principles and authorities.


Sec. 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 section 1.706-1(a). Such distributive share shall be determined as provided in section 704 and section 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 his 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 different from that which would result if that partner did not take the item into account separately. Thus, if any partner would qualify for the retirement income credit under section 37 if the partnership pensions and annuities, interest, rents, dividends, and earned income were separately stated, such items 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 his gross income the part of his 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. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 270 (relating to "hobby losses") and the recomputation of tax thereunder for any partner.

(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 section 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); and

(iv) In determining a partner’s “gross income from farming” (sections 175
and 6073).
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 reference.

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 section 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 section 1.613A-3(e).

Sec. 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 section 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.

Sec. 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 section 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 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 1/3 but less than or equal to 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 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. 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.


**Sec. 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 section 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

   (ii) As loss under section 702(a)(9), the total of all other allowable deductions (not separately stated) over the total of all other items of gross income (not separately stated).

The taxable income or loss so computed shall be accounted for by the partners in accordance with their partnership agreement.

(2) The partnership is not allowed the following deductions:

   (i) The standard deduction provided in section 141.

   (ii) The deduction for personal exemptions provided in section 151.

   (iii) The deduction provided in section 164(a) for taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States. Each partner's distributive share of such taxes shall be accounted for separately by him as provided in section 702(a)(6).

   (iv) The deduction for charitable contributions provided in section 170. Each partner is considered as having paid within his taxable year his distributive share of any contribution or gift, payment of which was actually made by the partnership within its taxable year ending within or with the partner's taxable year. This item shall be accounted for separately by the partners as provided in section 702(a)(4). See also paragraph (b) of section 1.702-1.
(v) The net operating loss deduction provided in section 172. See section 1.702-2.

(vi) The additional itemized deductions for individuals provided in Part VII, Subchapter B, Chapter 1 of the Code, as follows: Expenses for production of income (section 212); medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); and amounts representing taxes and interest paid to cooperative housing corporation (section 216). However, see paragraph (a)(8) of section 1.702-1.

(vii) The deduction for depletion under section 611 with respect to domestic oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such year.

(viii) The deduction for capital gains provided by section 1202 and the deduction for capital loss carryover provided by section 1212.

(b) Elections of the partnership--

(1) General rule.

Any elections (other than those described in subparagraph (2) of this paragraph) affecting the computation of income derived from a partnership shall be made by the partnership. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests.

(2) Exceptions.

(i) Each partner shall add his distributive share of taxes described in section 901 paid or accrued by the partnership to foreign countries or possessions of the United States (according to its method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

(ii) Each partner shall add his distributive share of expenses described in section 615 or section 617 paid or accrued by the partnership to any such expenses paid or accrued by him and shall treat the total amount according to his method of treating such expenses, notwithstanding the treatment of the expenses by the partnership.

(iii) Each partner who is a nonresident alien individual or a foreign corporation shall add his distributive share of income derived by the partnership from real property located in the United States, as described in section 871(d)(1) or 882(d)(1), to any such income derived by him and may elect under section 1.871-10 to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.
Sec. 1.704-1 Partner’s distributive share.

(a) Effect of partnership agreement.

A partner’s distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) Determination of partner’s distributive share--

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(1) In general--

   (i) Basic principles.

       Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section. Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. See paragraph (b)(3) of this section. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section and section 1.704-2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under paragraph (b)(3) of this section).

   (ii) Effective dates.

       The provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31, 1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(a) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986.
(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 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 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 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 paragraph (b)(2)(ii) of section 1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in section 1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

(iv) Other possible tax consequences.

Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of section 1.46-3, section 1.47-6, paragraph (b)(1) of section 1.721-1 (and related principles), and paragraph (e) of section 1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

(v) Purported allocations.

Section 704(b) and this paragraph do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see section 7701(a)(2) and paragraph (d) of section 301.7701-3) or to a person who is not receiving the purported allocation in his capacity as a partner (see section 707(a) and paragraph (a) of section 1.707-1).

(vi) Section 704(c) determinations.

Section 704(c) and section 1.704-3 generally require that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the variation between the adjusted tax basis and fair market value of the property. Although section 704(b) does not directly determine the partners' distributive
shares of tax items governed by section 704(c), the partners' distributive shares of tax items may be determined under section 704(c) and section 1.704-3 (depending on the allocation method chosen by the partnership under section 1.704-3) with reference to the partners' distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph. (See paragraphs (b)(2)(iv)(d) and (b)(4)(i) of this section.) See section 1.704-3 for methods of making allocations under section 704(c), and section 1.704-3(d)(2) for a special rule in determining the amount of book items if the remedial allocation method is chosen by the partnership. See also paragraph (b)(5) EXAMPLE (13)(i) of this section.

(vii) Bottom line allocations.

Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or "bottom line" taxable income and loss. An allocation to a partner of a share of partnership net or "bottom line" taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or "bottom line" taxable income or loss. See example (15)(i) of paragraph (b)(5) of this section.

(2) Substantial economic effect--

   (i) Two-part analysis.

   The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

   (ii) Economic effect--

      (a) Fundamental principles.

      In order 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 there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

      (b) Three requirements.

      Based on the principles contained in paragraph (b)(2)(ii)(a) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have 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 the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)).

For purposes of the preceding sentence, a partnership taxable year shall be determined without regard to section 706(c)(2)(A). Requirements (2) and (3) of this paragraph (b)(2)(ii)(b) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section. In addition, requirement (2) of this paragraph (b)(2)(ii)(b) is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in that requirement (2) in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances. See examples (1)(i) and (ii), (4)(i), (8)(i), and (16)(i) of paragraph (b)(5) of this section.
(c) Obligation to restore deficit.

If a partner is not expressly obligated to restore the deficit balance in his capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent of--

(1) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(2) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by State or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker), provided that such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in the previous sentence is negotiable, a partner will be considered required to satisfy such note within the time period specified in such sentence if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(d)(2) of this section. See examples (1)(ix) and (x) of paragraph (b)(5) of this section. A partner in no event will be considered obligated to restore the deficit balance in his capital account (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent such partner's obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation. See paragraphs (b)(2)(ii)(f), (b)(2)(ii)(h), and (b)(4)(vi) of this section for other rules regarding such obligation. For purposes of this paragraph (b)(2), if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988 and the maker of such note is a person related to such partner (within the meaning of section 1.752-1T(h), but without regard to subdivision (4) of that section), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(d) Alternate test for economic effect.

If--

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this
section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset,"

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for--

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made "(other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under section 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain)" under section 1.704-2 (f).

For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. See
examples (1)(iii), (iv), (v), (vi), (viii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

(e) Partial economic effect.

If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. See examples (15) (ii) and (iii) of paragraph (b)(5) of this section.

(f) Reduction of obligation to restore.

If requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, a partner's obligation to restore the deficit balance in his capital account (or any limited dollar amount thereof) to the partnership may be eliminated or reduced as of the end of a partnership taxable year without affecting the validity of prior allocations (see paragraph (b)(4)(vi) of this section) to the extent the deficit balance (if any) in such partner's capital account, after reduction for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section, will not exceed the partner's remaining obligation (if any) to restore the deficit balance in his capital account. See example (1)(viii) of paragraph (b)(5) of this section.

(g) Liquidation defined.

For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of section 1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner's obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section.

(h) Partnership agreement defined.

For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners,
whether oral or written, and whether or not embodied in a document referred to by 
the partners as the partnership agreement. Thus, in determining whether 
distributions are required in all cases to be made in accordance with the partners' 
positive capital account balances (requirement (2) of paragraph (b)(2)(ii)(b) of this 
section), and in determining the extent to which a partner is obligated to restore a 
deficit balance in his capital account (requirement (3) of paragraph (b)(2)(ii)(b) of this 
section), all arrangements among partners, or between one or more partners and 
the partnership relating to the partnership, direct and indirect, including puts, 
options, and other buy-sell agreements, and any other "stop-loss" arrangement, are 
considered to be part of the partnership agreement. (Thus, for example, if one 
partner who assumes a liability of the partnership is indemnified by another partner 
for a portion of such liability, the indemnifying partner (depending upon the particular 
facts) may be viewed as in effect having a partial deficit makeup obligation as a 
result of such indemnity agreement.) In addition, the partnership agreement includes 
provisions of Federal, State, or local law that govern the affairs of the partnership or 
are considered under such law to be a part of the partnership agreement (see the 
last sentence of paragraph (c) of section 1.761-1). For purposes of this paragraph 
(b)(2)(ii)(h), an agreement with a partner or a partnership shall include an agreement 
with a person related, within the meaning of section 267(b) (without modification by 
section 267(e)(1)) or section 707(b)(1), to such partner or partnership. For purposes 
of the preceding sentence, sections 267(b) and 707(b)(1) shall be applied for 
partnership taxable years beginning after December 29, 1988 by (1) substituting "80 
percent or more" for "more than 50 percent" each place it appears in such sections, 
(2) excluding brothers and sisters from the members of a person's family, and (3) 
disregarding section 267(f)(1)(A).

(i) Economic effect equivalence.

Allocations made to a partner that do not otherwise have economic 
effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to 
have economic effect, provided that as of the end of each partnership 
taxable year a liquidation of the partnership at the end of such year or at 
the end of any future year would produce the same economic results to 
the partners as would occur if requirements (1), (2), and (3) of paragraph 
(b)(2)(ii)(b) of this section had been satisfied, regardless of the economic 
performance of the partnership. See examples (4)(ii) and (iii) of 
paragraph (b)(5) of this section.

(iii) Substantiality--

(a) General rules.

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 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. See examples (5) and (9) of paragraph (b)(5) 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.

(b) Shifting tax consequences.

The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that--

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).

If, at the end of a partnership taxable year to which an allocation (or allocations) relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had the allocation (or allocations) not been contained in the partnership agreement, it will be presumed that, at the time the allocation (or allocations) became part of such partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (6), (7)(ii) and (iii), and (10)(ii) of paragraph (b)(5) of this section.

(c) Transitory allocations.
If a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that--

(1) The net increases and decreases that will be recorded in the partners’ respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners’ respective capital accounts for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)

the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. If, at the end of a partnership taxable year to which an offsetting allocation(s) relates, the net increases and decreases recorded in the partners’ respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners’ respective capital accounts had the original allocation(s) and the offsetting allocation(s) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had such allocations not been contained in the partnership agreement, it will be presumed that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section.

Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(c)) and, for purposes of paragraph (b)(2)(iii)(a), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example (2) of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its
adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples (1) (vi) and (xi) of paragraph (b)(5) of this section.

(iv) Maintenance of capital accounts--

(a) In general.

The economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(i) of this section, an allocation of income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

(b) Basic rules.

Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under section 752), (6) allocations to him of expenditures of the partnership described in section 705 (a)(2)(B), and (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding loss and deduction described in paragraph (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv). For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by
such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.

(c) Treatment of liabilities.

For purposes of this paragraph (b)(2)(iv), (1) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than liabilities described in paragraph (b)(2)(iv)(b)(5) of this section that are assumed by a distributee partner) but does not include increases in such partner’s share of partnership liabilities (see section 752(a)), and (2) money distributed to a partner by a partnership includes the amount of such partner’s individual liabilities that are assumed by the partnership (other than liabilities described in paragraph (b)(2)(iv)(b)(2) of this section that are assumed by the partnership) but does not include decreases in such partner’s share of partnership liabilities (see section 752(b)). For purposes of this paragraph (b)(2)(iv)(c), liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.

(d) Contributed property--

(1) In general.

The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution. See Example 13(i) of paragraph (b)(5) of this section. Consistent with section 752(c), section 7701(g) does not apply in determining such fair market value.

(2) Contribution of promissory notes.

Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(2) of this section, except as provided in this paragraph (b)(2)(iv)(d)(2), if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner's capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note. See example (1)(ix) of paragraph (b)(5) of this section. The first sentence of this paragraph (b)(2)(iv)(d)(2) shall not apply if the note referred to therein is readily tradable on an established securities market. See also paragraph (b)(2)(ii)(c) of this section. Furthermore, a partner whose interest is liquidated will be considered as satisfying his obligation to restore the deficit balance in his capital account to the extent of (i) the fair market value, at the time of contribution, of any negotiable promissory note (of which such partner is the maker) that such partner contributes to the partnership
on or after the date his interest is liquidated and within the time
specified in paragraph (b)(2)(ii)(b)(3) of this section, and (ii) the fair
market value, at the time of liquidation, of the unsatisfied portion of
any negotiable promissory note (of which such partner is the maker)
that such partner previously contributed to the partnership. For
purposes of the preceding sentence, the fair market value of a note
will be no less than the outstanding principal balance of such note,
provided that such note bears interest at a rate no less than the
applicable federal rate at the time of valuation.

(3) Section 704(c) considerations.

Section 704(c) and section 1.704-3 govern the determination of
the partners' distributive shares of income, gain, loss, and deduction,
as computed for tax purposes, with respect to property contributed to
a partnership (see paragraph (b)(1)(vi) of this section ). In cases
where section 704(c) and section 1.704-3 apply to partnership
property, the capital accounts of the partners will not be considered to
be determined and maintained in accordance with the rules of this
paragraph (b)(2)(iv) unless the partnership agreement requires that
the partners' capital accounts be adjusted in accordance with
paragraph (b)(2)(iv)(g) of this section for allocations to them of
income, gain, loss, and deduction (including depreciation, depletion,
amortization, or other cost recovery) as computed for book purposes,
with respect to the property. See, however, section 1.704-3(d)(2) for a
special rule in determining the amount of book items if the partnership
chooses the remedial allocation method. See also EXAMPLE (13)(i)
of paragraph (b)(5) of this section. Capital accounts are not adjusted
to reflect allocations under section 704(c) and section 1.704-3 (e.g.,
tax allocations of precontribution gain or loss).

(e) Distributed property--

(1) In general.

The basic capital accounting rules contained in paragraph
(b)(2)(iv) (b) of this section require that a partner’s capital account be
decreased by the fair market value of property distributed by the
partnership (without regard to section 7701(g)) to such partner
(whether in connection with a liquidation or otherwise). To satisfy this
requirement, the capital accounts of the partners first must be
adjusted to reflect the manner in which the unrealized income, gain,
loss, and deduction inherent in such property (that has not been
reflected in the capital accounts previously) would be allocated
among the partners if there were a taxable disposition of such
property for the fair market value of such property (taking section
7701(g) into account) on the date of distribution. See example (14)(v)
of paragraph (b)(5) of this section.

(2) Distribution of promissory notes.
Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5),
except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory
note is distributed to a partner by a partnership that is the maker of
such note, such partner's capital account will be decreased with
respect to such note only when there is a taxable disposition of such
note by the partner or when the partnership makes principal
payments on the note. The previous sentence shall not apply if a note
distributed to a partner by a partnership who is the maker of such
note is readily tradable on an established securities market.
Furthermore, the capital account of a partner whose interest in a
partnership is liquidated will be reduced to the extent of (i) the fair
market value, at the time of distribution, of any negotiable promissory
note (of which such partnership is the maker) that such partnership
distributes to the partner on or after the date such partner's interest is
liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of
this section, and (ii) the fair market value, at the time of liquidation, of
the unsatisfied portion of any negotiable promissory note (of which
such partnership is the maker) that such partnership previously
distributed to the partner. For purposes of the preceding sentence,
the fair market value of a note will be no less than the outstanding
principal balance of such note, provided that such note bears interest
at a rate no less than the applicable federal rate at time of valuation.

(f) Revaluations of property.

A partnership agreement may, upon the occurrence of certain events,
increase or decrease the capital accounts of the partners to reflect a
revaluation of partnership property (including intangible assets such as
goodwill) on the partnership's books. Capital accounts so adjusted will not
be considered to be determined and maintained in accordance with the
rules of this paragraph (b)(2)(iv) unless--

(1) The adjustments are based on the fair market value of
partnership property (taking section 7701(g) into account) on the date
of adjustment, and

(2) The adjustments reflect the manner in which the unrealized
income, gain, loss, or deduction inherent in such property (that has
not been reflected in the capital accounts previously) would be
allocated among the partners if there were a taxable disposition of
such property for such fair market value on that date, and

(3) The partnership agreement requires that the partners' capital
accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of
this section for allocations to them of depreciation, depletion,
amortization, and gain or loss, as computed for book purposes, with
respect to such property, and

(4) The partnership agreement requires that the partners'
distributive shares of depreciation, depletion, amortization, and gain
or loss, as computed for tax purposes, with respect to such property
be determined so as to take account of the variation between the
adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and

(5) The adjustments are made principally for a substantial non-tax business purpose--

(i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or

(ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or

(iii) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

See example (14) and (18) of paragraph (b)(5) of this section. If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property.

(g) Adjustments to reflect book value--

(1) In general.

Under paragraphs (b)(2)(iv)(d) and (b)(2)(iv)(f) of this section, property may be properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property. In these circumstances, paragraphs (b)(2)(iv)(d)(3) and (b)(2)(iv)(f)(3) of this section provide that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires the partners' capital accounts to be adjusted in accordance with this paragraph (b)(2)(iv)(g) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property. In determining whether the economic effect of an allocation of book items is substantial, consideration will be given to the effect of such allocation on the determination of the partners' distributive shares of corresponding tax items under section 704(c) and paragraph (b)(4)(i) of this section. See example (17) of paragraph (b)(5) of this section.
an allocation of book items under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under section 704(c) and paragraph (b)(4)(i) of this section. See examples (13), (14), and (18) of paragraph (b)(5) of this section.

(2) Payables and receivables.

References in this paragraph (b)(2)(iv) and paragraph (b)(4)(i) of this section to book and tax depreciation, depletion, amortization, and gain or loss with respect to property that has an adjusted tax basis that differs from book value include, under analogous rules and principles, the unrealized income or deduction with respect to accounts receivable, accounts payable, and other accrued but unpaid items.

(3) Determining amount of book items.

The partners' capital accounts will not be considered adjusted in accordance with this paragraph (b)(2)(iv)(g) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. If such property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership.

(h) Determinations of fair market value.

For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.

(i) Section 705(a)(2)(B) expenditures--
(1) In general.

The basic capital accounting rules contained in paragraph
(b)(2)(iv)(b) of this section require that a partner's capital account be
decreased by allocations made to such partner of expenditures
described in section 705(a)(2)(B). See example (11) of paragraph
(b)(5) of this section. If an allocation of these expenditures under the
partnership agreement does not have substantial economic effect (as
determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section),
or is not otherwise respected under this paragraph, such expenditures
will be reallocated in accordance with the partners' interest in the
partnership.

(2) Expenses described in section 709.

Except for amounts with respect to which an election is properly
made under section 709(b), amounts paid or incurred to organize a
partnership or to promote the sale of (or to sell) an interest in such a
partnership shall, solely for purposes of this paragraph, be treated as
section 705(a)(2)(B) expenditures, and upon liquidation of the
partnership no further capital account adjustments will be made in
respect thereof.

(3) Disallowed losses.

If a deduction for a loss incurred in connection with the sale or
exchange of partnership property is disallowed to the partnership
under section 267(a)(1) or section 707(b), that deduction shall, solely
for purposes of this paragraph, be treated as a section 705(a)(2)(B)
expenditure.

(j) Basis adjustments to section 38 property.

The capital accounts of the partners will not be considered to be
determined and maintained in accordance with the rules of this paragraph
(b)(2)(iv) unless such capital accounts are adjusted by the partners' shares of any upward or downward basis adjustments allocated to them under this paragraph (b)(2)(iv)(j). When there is a reduction in the
adjusted tax basis of partnership section 38 property under section
48(q)(1) or section 48(q)(3), section 48(q)(6) provides for an equivalent
downward adjustment to the aggregate basis of partnership interests
(and no additional adjustment is made under section 705(a)(2)(B)). These
downward basis adjustments shall be shared among the partners in the
same proportion as the adjusted tax basis or cost of (or the qualified
investment in) such section 38 property is allocated among the partners
under paragraph (f) of section 1.46-3 (or paragraph (a)(4)(iv) of section
1.48-8). Conversely, when there is an increase in the adjusted tax basis
of partnership section 38 property under section 48(q)(2), section
48(q)(6) provides for an equivalent upward adjustment to the aggregate
basis of partnership interests. These upward adjustments shall be
allocated among the partners in the same proportion as the investment
(k) Depletion of oil and gas properties--

(1) In general.

The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted for depletion and gain or loss with respect to the oil or gas properties of the partnership in accordance with this paragraph (b)(2)(iv)(k).

(2) Simulated depletion.

Except as provided in paragraph (b)(2)(iv)(k) (3) of this section, a partnership shall, solely for purposes of maintaining capital accounts under this paragraph, compute simulated depletion allowances with respect to its oil and gas properties at the partnership level. These allowances shall be computed on each depletable oil or gas property of the partnership by using either the cost depletion method or the percentage depletion method (computed in accordance with section 613 at the rates specified in section 613A(c)(5) without regard to the limitations of section 613A, which theoretically could apply to any partner) for each partnership taxable year that the property is owned by the partnership and subject to depletion. The choice between the simulated cost depletion method and the simulated percentage depletion method shall be made on a property-by-property basis in the first partnership taxable year beginning after April 30, 1986, for which it is relevant for the property, and shall be binding for all partnership taxable years during which the oil or gas property is held by the partnership. The partnership shall make downward adjustments to the capital accounts of the partners for the simulated depletion allowance with respect to each oil or gas property of the partnership, in the same proportion as such partners (or their predecessors in interest) were properly allocated the adjusted tax basis of each such property. The aggregate capital account adjustments for simulated percentage depletion allowances with respect to an oil or gas property of the partnership shall not exceed the aggregate adjusted tax basis allocated to the partners with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, such partnership’s simulated gain or loss shall be determined by subtracting its simulated adjusted basis in such property from the amount realized upon such disposition. (The partnership’s simulated adjusted basis in an oil or gas property is determined in the same manner as adjusted tax basis except that simulated depletion allowances are taken into account instead of actual depletion allowances.) The capital accounts of the partners shall be adjusted upward by the amount of any simulated gain in proportion to such partners’ allocable shares of the portion of the total amount realized from the disposition of such property that exceeds the partnership’s simulated adjusted basis in such property. The
capital accounts of such partners shall be adjusted downward by the amount of any simulated loss in proportion to such partners' allocable shares of the total amount realized from the disposition of such property that represents recovery of the partnership's simulated adjusted basis in such property. See section 613A(c)(7)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section. See example (19)(iv) of paragraph (b)(5) of this section.

(3) Actual depletion.

Pursuant to section 613A(c)(7)(D) and the regulations thereunder, the depletion allowance under section 611 with respect to the oil and gas properties of a partnership is computed separately by the partners. Accordingly, in lieu of adjusting the partner's capital accounts as provided in paragraph (b)(2)(iv)(k)(2) of this section, the partnership may make downward adjustments to the capital account of each partner equal to such partner's depletion allowance with respect to each oil or gas property of the partnership (for the partner's taxable year that ends with or within the partnership's taxable year). The aggregate adjustments to the capital account of a partner for depletion allowances with respect to an oil or gas property of the partnership shall not exceed the adjusted tax basis allocated to such partner with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, the capital account of each partner shall be adjusted upward by the amount of any excess of such partner's allocable share of the total amount realized from the disposition of such property over such partner's remaining adjusted tax basis in such property. If there is no such excess, the capital account of such partner shall be adjusted downward by the amount of any excess of such partner's remaining adjusted tax basis in such property over such partner's allocable share of the total amount realized from the disposition thereof. See section 613A(c)(7)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section.

(4) Effect of book values.

If an oil or gas property of the partnership is, under paragraphs (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the rules contained in this paragraph (b)(2)(iv)(k) and paragraph (b)(4)(v) of this section shall be applied with reference to such book value. A revaluation of a partnership oil or gas property under paragraph (b)(2)(iv)(f) of this section may give rise to a reallocation of the adjusted tax basis of such property, or a change in the partners' relative shares of simulated depletion from such property, only to the extent permitted by section 613A(c)(7)(D) and the regulations thereunder.

(l) Transfers of partnership interests.
The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See paragraph (b)(2)(iv)(m) of this section for rules concerning the effect of a section 754 election on the capital accounts of the partners.) If the transfer of an interest in a partnership causes a termination of the partnership under section 708(b)(1)(B), the capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership under section 1.708-1(b)(1)(iv). Moreover, the deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur under section 1.708-1(b)(1)(iv) are disregarded for purposes of paragraph (b)(2)(iv) of this section. See Example 13 of paragraph (b)(5) of this section and the example in section 1.708-1(b)(1)(iv). The previous three sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(m) Section 754 elections--

(1) In general.

The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon adjustment to the adjusted tax basis of partnership property under section 732, 734, or 743, the capital accounts of the partners are adjusted as provided in this paragraph (b)(2)(iv)(m).

(2) Section 743 adjustments.

In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions (see paragraph (b)(2)(iv)(e)(1) of this section) and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment. The preceding sentence shall not apply to the extent such basis adjustment is allocated to the common basis of partnership property under paragraph (b)(1) of section 1.734-2; in these cases, such basis adjustment shall, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, give rise to adjustments to the capital accounts of the partners in accordance with their interests.
in the partnership under paragraph (b)(3) of this section. See examples (13) (iii) and (iv) of paragraph (b)(5) of this section.

(3) Section 732 adjustments.

In the case of a transfer of all or a part of an interest in a partnership that does not have a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 732(d) will be treated in the capital accounts of the partners in the same manner as section 743 basis adjustments are treated under paragraph (b)(2)(iv)(m)(2) of this section.

(4) Section 734 adjustments.

Except as provided in paragraph (b)(2)(iv)(m)(5) of this section, in the case of a distribution of property in liquidation of a partner’s interest in the partnership by a partnership that has a section 754 election in effect for the partnership taxable year in which the distribution occurs, the partner who receives the distribution that gives rise to the adjustment to the adjusted tax basis of partnership property under section 734 shall have a corresponding adjustment made to his capital account. If such distribution is made other than in liquidation of a partner's interest in the partnership, however, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, the capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to such adjustment for its recomputed adjusted tax basis.

(5) Limitations on adjustments.

Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

(n) Partnership level characterization.

Except as otherwise provided in paragraph (b)(2)(iv)(k) of this section, the capital accounts of the partners will not be considered to be
determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless adjustments to such capital accounts in respect of partnership income, gain, loss, deduction, and section 705(a)(2)(B) expenditures (or item thereof) are made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level (for example, under section 58(i)). However, a partnership that incurs mining exploration expenditures will determine the Federal tax treatment of income, gain, loss, and deduction with respect to the property to which such expenditures relate at the partnership level only after first taking into account the elections made by its partners under section 617 and section 703(b)(4).

(o) Guaranteed payments.

Guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner’s distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.

(p) Minor discrepancies.

Discrepancies between the balances in the respective capital accounts of the partners and the balances that would be in such respective capital accounts if they had been determined and maintained in accordance with this paragraph (b)(2)(iv) will not adversely affect the validity of an allocation, provided that such discrepancies are minor and are attributable to good faith error by the partnership.

(q) Adjustments where guidance is lacking.

If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership’s balance sheet, as computed for book purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based, wherever practicable, on Federal tax accounting principles.

(r) Restatement of capital accounts.

With respect to partnerships that began operating in a taxable year beginning before May 1, 1986, the capital accounts of the partners of which have not been determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) since inception, such capital accounts shall not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) for taxable years beginning after April 30, 1986, unless either--
(1) Such capital accounts are adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year, and in connection with such adjustment, the rules contained in paragraph (b)(2)(iv)(f) (2), (3), and (4) of this section are satisfied, or

(2) The differences between the balance in each partner's capital account and the balance that would be in such partner's capital account if capital accounts had been determined and maintained in accordance with this paragraph (b)(2)(iv) throughout the full term of the partnership are not significant (for example, such differences are solely attributable to a failure to provide for treatment of section 709 expenses in accordance with the rules of paragraph (b)(2)(iv)(i)(2) of this section or to a failure to follow the rules in paragraph (b)(2)(iv)(m) of this section), and capital accounts are adjusted to bring them into conformity with the rules of this paragraph (b)(2)(iv) no later than the end of the first partnership taxable year beginning after April 30, 1986.

With respect to a partnership that began operating in a taxable year beginning before May 1, 1986, modifications to the partnership agreement adopted on or before November 1, 1988, to make the capital account adjustments required to comply with this paragraph, and otherwise to satisfy the requirements of this paragraph, will be treated as if such modifications were included in the partnership agreement before the end of the first partnership taxable year beginning after April 30, 1986.

However, compliance with the previous sentences will have no bearing on the validity of allocations that relate to partnership taxable years beginning before May 1, 1986.

(3) Partner's interest in the partnership--

(i) In general.

References in section 704(b) and this paragraph 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. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination
of a partner’s interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. All partners’ interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners’ interests in the partnership are otherwise.

(ii) Factors considered.

In determining a partner’s interest in the partnership, the following factors are among those that will be considered:

(a) The partners’ relative contributions to the partnership,

(b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(c) The interests of the partners in cash flow and other non-liquidating distributions, and

(d) The rights of the partners to distributions of capital upon liquidation.

The provisions of this subparagraph (b)(3) are illustrated by examples (1)(i) and (ii), (4)(i), (5)(i) and (ii), (6), (7), (8), (10)(i), (16)(i), and (19)(iii) of paragraph (b)(5) of this section. See paragraph (b)(4)(i) of this section concerning rules for determining the partners’ interests in the partnership with respect to certain tax items.

(iii) Certain determinations.

If--

(a) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(b) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect under paragraph (b)(2)(ii) of this section.

the partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is
insubstantial under paragraph (b)(2)(iii) of this section. See examples (1) (iv), (v), and (vi), and (15) (ii) and (iii) of paragraph (b)(5) of this section.

(4) Special rules--

(i) Allocations to reflect revaluations.

If partnership property is, under paragraphs (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property. In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners (see paragraph (b)(2)(iv)(g) of this section), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate allocations of these tax items cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the partners' distributive shares of such tax items must (unless governed by section 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c). See examples (14) and (18) of paragraph (b)(5) of this section.

(ii) Credits.

Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits and tax credit recapture give rise to capital account adjustments under paragraph (b)(2)(iv)(j) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to the investment tax credit provided by section 38, allocations of cost or qualified investment made in accordance with paragraph (f) of section 1.46-3 and paragraph (a)(4)(iv) of section 1.48-8 shall be deemed to be made in accordance with the partners' interests in the partnership. With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). See example (11) of paragraph (b)(5) of this section. Identical principles shall
apply in determining the partners' interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).

(iii) Excess percentage depletion.

To the extent the percentage depletion in respect of an item of depletable property of the partnership exceeds the adjusted tax basis of such property, allocations of such excess percentage depletion are not reflected by adjustments to the partners' capital accounts. Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and such excess percentage depletion must be allocated in accordance with the partners' interests in the partnership. The partners' interests in the partnership for a partnership taxable year with respect to such excess percentage depletion shall be in the same proportion as such partners' respective distributive shares of gross income from the depletable property (as determined under section 613(c)) for such year. See example (12) of paragraph (b)(5) of this section. See paragraphs (b)(2)(iv)(k) and (b)(4)(v) of this section for special rules concerning oil and gas properties of the partnership.

(iv) ALLOCATIONS ATTRIBUTABLE TO NONRECURSIVE LIABILITIES.

The rules for allocations attributable to nonrecourse liabilities are contained in section 1.704-2.

(v) Allocations under section 613A(c)(7)(D).

Allocations of the adjusted tax basis of a partnership oil or gas property are controlled by section 613A(c)(7)(D) and the regulations thereunder. However, if the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners, and such allocation is not otherwise governed by section 704(c) (or related principles under paragraph (b)(4)(i) of this section), that allocation will be recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), provided (a) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(k) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(iii) of this section), and (b) all other material allocations and capital account adjustments under the partnership agreement are recognized under this paragraph (b). Otherwise, such adjusted tax basis must be allocated among the partners pursuant to section 613A(c)(7)(D) in accordance with the partners' actual interests in partnership capital or income. For purposes of section 613A(c)(7)(D) the partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property will, except to the extent governed by section 704(c) (or related principles under paragraph (b)(4)(i) of this section), be determined under this paragraph (b)(4)(v). If, pursuant to paragraph (b)(2)(iv)(k)(2) of this section, the partners' capital accounts are adjusted to reflect the simulated depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that represents recovery of its simulated adjusted tax basis therein will be
allocated to the partners in the same proportion as the aggregate adjusted tax basis of such property was allocated to such partners (or their predecessors in interest). If, pursuant to paragraph (b)(2)(iv)(k)(3) of this section, the partners’ capital accounts are adjusted to reflect the actual depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that equals the partners’ aggregate remaining adjusted basis therein will be allocated to the partners in proportion to their respective remaining adjusted tax bases in such property. An allocation provided by the partnership agreement of the portion of the total amount realized by the partnership on its taxable disposition of an oil or gas property that exceeds the portion of the total amount realized allocated under either of the previous two sentences (whichever is applicable) shall be deemed to be made in accordance with the partners’ allocable shares of such amount realized, provided (c) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(k) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(ii) of this section), and (d) all other allocations and capital account adjustments under the partnership agreement are recognized under this paragraph. Otherwise, the partners’ allocable shares of the total amount realized by the partnership on its taxable disposition of an oil or gas property shall be determined in accordance with the partners’ interests in the partnership under paragraph (b)(3) of this section. See example (19) of paragraph (b)(5) of this section.

(See paragraph (b)(2)(iv)(k) of this section for the determination of appropriate adjustments to the partners’ capital accounts relating to section 613A(c)(7)(D).)

(vi) Amendments to partnership agreement.

If an allocation has substantial economic effect under paragraph (b)(2) of this section or is deemed to be made in accordance with the partners’ interests in the partnership under paragraph (b)(4) of this section under the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement. If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership agreement to restore the deficit balance in his capital account (or any limited dollar amount thereof) in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section and, thereafter, such obligation is eliminated or reduced (other than as provided in paragraph (b)(2)(ii)(f) of this section), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if it always were part of the partnership agreement for purposes of making any reallocations and determining the appropriate limitations period.

(vii) Recapture.
For special rules applicable to the allocation of recapture income or credit, see paragraph (e) of section 1.1245-1, paragraph (f) of section 1.1250-1, paragraph (c) of section 1.1254-1, and paragraph (a) of section 1.47-6.

(5) Examples.

The operation of the rules in this paragraph is illustrated by the following examples:

Example (1). (i) A and B form a general partnership with cash contributions of $40,000 each, which cash is used to purchase depreciable personal property at a cost of $80,000. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that A and B will have equal shares of taxable income and loss (computed without regard to cost recovery deductions) and cash flow and that all cost recovery deductions on the property will be allocated to A. The agreement further provides that the partners’ capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of the section, but that upon liquidation of the partnership, distributions will be made equally between the partners (regardless of capital account balances) and no partner will be required to restore the deficit balance in his capital account for distribution to partners with positive capital account balances. In the partnership’s first taxable year, it recognizes operating income equal to its operating expenses and has an additional $20,000 cost recovery deduction, which is allocated entirely to A. That A and B will be entitled to equal distributions on liquidation, even though A is allocated the entire $20,000 cost recovery deduction, indicates A will not bear the full risk of the economic loss corresponding to such deduction if such loss occurs. Under paragraph (b)(2)(ii) of this section, the allocation lacks economic effect and will be disregarded. The partners made equal contributions to the partnership, share equally in other taxable income and loss and in cash flow, and will share equally in liquidation proceeds, indicating that their actual economic arrangement is to bear the risk imposed by the potential decrease in the value of the property equally. Thus, under paragraph (b)(3) of this section the partners’ interests in the partnership are equal, and the cost recovery deduction will be reallocated equally between A and B.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that liquidation proceeds will be distributed in accordance with capital account balances if the partnership is liquidated during the first five years of its existence but that liquidation proceeds will be distributed equally if the partnership is liquidated thereafter. Since the partnership agreement does not provide for the requirement contained in paragraph (b)(2)(ii)(b)(2) of this section to be satisfied throughout the term of the partnership, the partnership allocations do not have economic effect. Even if the partnership agreement provided for the requirement contained in paragraph (b)(2)(ii)(b)(2) to be satisfied throughout the term of the partnership, such allocations would not have economic effect unless the requirement contained in paragraph (b)(2)(ii)(b)(3) of this section or the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section were satisfied.
(iii) Assume the same facts as in (i) except that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(ii)(d)(4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in A's capital account.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account upon formation</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less: year 1 cost recovery deduction($20,000)</td>
<td>0</td>
</tr>
<tr>
<td>Capital account at end of year 1</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section, the allocation of the $20,000 cost recovery deduction to A has economic effect.

(iv) Assume the same facts as in (iii) and that in the partnership's second taxable year it recognizes operating income equal to its operating expenses and has a $25,000 cost recovery deduction which, under the partnership agreement, is allocated entirely to A.

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at beginning of year 2</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: year 2 cost recovery deduction($25,000)</td>
<td>0</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>($5,000)</td>
</tr>
</tbody>
</table>

The allocation of the $25,000 cost recovery deduction to A satisfies that alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section only to the extent of $20,000. Therefore, only $20,000 of such allocation has economic effect, and the remaining $5,000 must be reallocated in accordance with the partners' interests in the partnership. Under the partnership agreement, if the property were sold immediately following the end of the partnership's second taxable year for $35,000 (its adjusted tax basis), the $35,000 would be distributed to B. Thus, B, and not A, bears the economic burden corresponding to $5,000 of the $25,000 cost recovery deduction allocated to A. Under paragraph (b)(3)(iii) of this section, $5,000 of such cost recovery deduction will be reallocated to B.

(v) Assume the same facts as in (iv) except that the cost recovery deduction for the partnership's second taxable year is $20,000 instead of $25,000. The allocation of such cost recovery deduction to A has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section. Assume further that the property is sold for $35,000 immediately following the end of the partnership's second taxable year, resulting in a $5,000 taxable loss ($40,000 adjusted tax basis less $35,000 sales price), and the partnership is liquidated.
Under the partnership agreement the $35,000 sales proceeds are distributed to B. Since B bears the entire economic burden corresponding to the $5,000 taxable loss from the sale of the property, the allocation of $2,500 of such loss to A does not have economic effect and must be reallocated in accordance with the partners’ interests in the partnership. Under paragraph (b)(3)(iii) of this section, such $2,500 loss will be reallocated to B.

(vi) Assume the same facts as in (iv) except that the cost recovery deduction for the partnership's second taxable year is $20,000 instead of $25,000, and that as of the end of the partnership's second taxable year it is reasonably expected that during its third taxable year the partnership will (1) have operating income equal to its operating expenses (but will have no cost recovery deductions), (2) borrow $10,000 (recourse) and distribute such amount $5,000 to A and $5,000 to B, and (3) thereafter sell the partnership property, repay the $10,000 liability, and liquidate. In determining the extent to which the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section is satisfied as of the end of the partnership's second taxable year, the fair market value of partnership property is presumed to be equal to its adjusted tax basis (in accordance with paragraph (b)(2)(iii)(c) of this section). Thus, it is presumed that the selling price of such property during the partnership's third taxable year will be its $40,000 adjusted tax basis. Accordingly, there can be no reasonable expectation that there will be increases to A's capital account in the partnership's third taxable year that will offset the expected $5,000 distribution to A. Therefore, the distribution of the loan proceeds must be taken into account in determining to what extent the alternate economic effect test contained in paragraph (b)(2)(ii)(d) is satisfied.

Capital account at beginning of year 2 A $20,000 B $40,000
Less: year 2 cost recovery deduction ($20,000) 0
Capital account at end of year 2 0 B $40,000
Less: loss on sale ($2,500) ($2,500)
Capital account before liquidation ($2,500) $37,500

Upon sale of the partnership property, the $40,000 presumed sales proceeds would be used to repay the $10,000 liability, and the remaining $30,000 would be distributed to B. Under these circumstances the allocation of the $20,000 cost recovery deduction to A in the partnership's second taxable year satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section only to the extent of $15,000. Under paragraph (b)(3)(iii) of this section, the remaining $5,000 of such deduction will be reallocated to B. The results in this example would be the same even if the partnership agreement also provided that any gain (whether ordinary income or capital gain) upon the sale of the property
would be allocated to A to the extent of the prior allocations of cost recovery deductions to him, and, at end of the partnership's second taxable year, the partners were confident that the gain on the sale of the property in the partnership's third taxable year would be sufficient to offset the expected $5,000 distribution to A.

(vii) Assume the same facts as in (iv) except that the partnership agreement also provides that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(3) of this section). Thus, if the property were sold for $35,000 immediately after the end of the partnership's second taxable year, the $35,000 would be distributed to B, A would contribute $5,000 (the deficit balance in his capital account) to the partnership, and that $5,000 would be distributed to B. The allocation of the entire $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(viii) Assume the same facts as in (vii) except that A's obligation to restore the deficit balance in his capital account is limited to a maximum of $5,000. The allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section. At the end of such year, A makes an additional $5,000 contribution to the partnership (thereby eliminating the $5,000 deficit balance in his capital account). Under paragraph (b)(2)(ii)(f) of this section, A's obligation to restore up to $5,000 of the deficit balance in his capital account may be eliminated after he contributes the additional $5,000 without affecting the validity of prior allocations.

(ix) Assume the same facts as in (iv) except that upon formation of the partnership A also contributes to the partnership his negotiable promissory note with a $5,000 principal balance. The note unconditionally obligates A to pay an additional $5,000 to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(c) of this section, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect. The results in this example would be the same if (1) the note A contributed to the partnership were payable only at the end of the partnership's fourth taxable year (so that A would not be required to satisfy the note upon liquidation of his interest in the partnership), and (2) the partnership agreement provided that upon liquidation of A's interest, the partnership would retain A's note, and A would contribute to the partnership the excess of the outstanding principal balance of the note over its then fair market value.

(x) Assume the same facts as in (ix) except that A's obligation to contribute an additional $5,000 to the partnership is not evidenced by a promissory note. Instead, the partnership agreement imposes upon A the obligation to make an additional $5,000 contribution to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(c) of this section, as a result of A's deferred contribution requirement, A
is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(xi) Assume the same facts as in (vii) except that the partnership agreement also provides that any gain (whether ordinary income or capital gain) upon the sale of the property will be allocated to A to the extent of the prior allocations to A of cost recovery deductions from such property, and additional gain will be allocated equally between A and B. At the time the allocations of cost recovery deductions were made to A, the partners believed there would be gain on the sale of the property in an amount sufficient to offset the allocations of cost recovery deductions to A. Nevertheless, the existence of the gain chargeback provision will not cause the economic effect of the allocations to be insubstantial under paragraph (b)(2)(iii)(c) of this section, since in testing whether the economic effect of such allocations is substantial, the recovery property is presumed to decrease in value by the amount of such deductions.

Example (2). C and D form a general partnership solely to acquire and lease machinery that is 5-year recovery property under section 168. Each contributes $100,000, and the partnership obtains an $800,000 recourse loan to purchase the machinery. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such machinery. The partnership, C, and D have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership agreement further provides that (a) partnership net taxable loss will be allocated 90 percent to C and 10 percent to D until such time as there is partnership net taxable income, and therefore C will be allocated 90 percent of such taxable income until he has been allocated partnership net taxable income equal to the partnership net taxable loss previously allocated to him, (b) all further partnership net taxable income or loss will be allocated equally between C and D, and (c) distributions of operating cash flow will be made equally between C and D. The partnership enters into a 12-year lease with a financially secure corporation under which the partnership expects to have a net taxable loss in each of its first 5 partnership taxable years due to cost recovery deductions with respect to the machinery and net taxable income in each of its following 7 partnership taxable years, in part due to the absence of such cost recovery deductions. There is a strong likelihood that the partnership's net taxable loss in partnership taxable years 1 through 5 will be $100,000, $90,000, $80,000, $70,000, and $60,000, respectively, and the partnership's net taxable income in partnership taxable years 6 through 12 will be $40,000, $50,000, $60,000, $70,000, $80,000, $90,000, and $100,000, respectively. Even though there is a strong likelihood that the allocations of net taxable loss in years 1 through 5 will be largely offset by other allocations in partnership taxable years 6 through 12, and even if it is
assumed that the total tax liability of the partners in years 1 through 12 will be less than if the allocations had not been provided in the partnership agreement, the economic effect of the allocations will not be insubstantial under paragraph (b)(2)(iii)(c) of this section. This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocations of net taxable loss in years 1 through 5 would not be largely offset by allocations of income within 5 years (determined on a first-in, first-out basis). The year 1 allocation will not be offset until years 6, 7, and 8, the year 2 allocation will not be offset until years 8 and 9, the year 3 allocation will not be offset until years 9 and 10, the year 4 allocation will not be offset until years 10 and 11, and the year 5 allocation will not be offset until years 11 and 12.

Example (3). E and F enter into a partnership agreement to develop and market experimental electronic devices. E contributes $2,500 cash and agrees to devote his full-time services to the partnership. F contributes $100,000 cash and agrees to obtain a loan for the partnership for any additional capital needs. The partnership agreement provides that all deductions for research and experimental expenditures and interest on partnership loans are to be allocated to F. In addition, F will be allocated 90 percent, and E 10 percent, of partnership taxable income or loss, computed net of the deductions for such research and experimental expenditures and interest, until F has received allocations of such taxable income equal to the sum of such research and experimental expenditures, such interest expense, and his share of such taxable loss. Thereafter, E and F will share all taxable income and loss equally. Operating cash flow will be distributed equally between E and F. The partnership agreement also provides that E’s and F’s capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner’s interest) will be made in accordance with the partners’ positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). These allocations have economic effect. In addition, in view of the nature of the partnership’s activities, there is not a strong likelihood at the time the allocations become part of the partnership agreement that the economic effect of the allocations to F of deductions for research and experimental expenditures and interest on partnership loans will be largely offset by allocations to F of partnership net taxable income. The economic effect of the allocations is substantial.

Example (4). (i) G and H contribute $75,000 and $25,000, respectively, in forming a general partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated equally between the partners, that the partners’ capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, but that all partnership distributions will, regardless of capital account balances, be made 75 percent to G and 25 percent to H. Following the liquidation of the partnership, neither partner is required to restore the deficit balance in his capital account to the partnership for distribution to partners with positive capital account balances. The allocations in the partnership agreement do not have economic effect. Since contributions were made in a 75/25 ratio and the partnership agreement indicates that all economic profits and losses of the partnership are to be shared
in a 75/25 ratio, under paragraph (b)(3) of this section, partnership income, gain, loss, and deduction will be reallocated 75 percent to G and 25 percent to H.

(ii) Assume the same facts as in (i) except that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. G and H are ultimately liable (under a State law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.

(iii) Assume the same facts as in (i) except that the partnership agreement provides that any partner with a deficit balance in his capital account must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.

Example (5). (i) Individuals I and J are the only partners of an investment partnership. The partnership owns corporate stocks, corporate debt instruments, and tax-exempt debt instruments. Over the next several years, I expects to be in the 50 percent marginal tax bracket, and J expects to be in the 15 percent marginal tax bracket. There is a strong likelihood that in each of the next several years the partnership will realize between $450 and $550 of tax-exempt interest and between $450 and $550 of a combination of taxable interest and dividends from its investments. I and J made equal capital contributions to the partnership, and they have agreed to share equally in gains and losses from the sale of the partnership's investment securities. I and J agree, however, that rather than share interest and dividends of the partnership equally, they will allocate the partnership's tax-exempt interest 80 percent to I and 20 percent to J and will distribute cash derived from interest received on the tax-exempt bonds in the same percentages. In addition, they agree to allocate 100 percent of the partnership's taxable interest and dividends to J and to distribute cash derived from interest and dividends received on the corporate stocks and debt instruments 100 percent to J. The partnership agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The allocation of taxable interest and dividends and tax-exempt interest has economic effect, but that economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. Without the allocation I would be allocated between $225 and $275 of tax-exempt interest and between $225 and $275 of a combination of taxable interest and dividends, which (net of Federal income taxes he would owe on such income) would give I between $337.50 and $412.50 after tax. With the allocation, however, I will be allocated between $360 and $440 of tax-exempt interest and no taxable interest and dividends, which (net of Federal income taxes) will give I between $360 and
$440 after tax. Thus, at the time the allocations became part of the partnership agreement, I is expected to enhance his after-tax economic consequences as a result of the allocations. On the other hand, there is a strong likelihood that neither I nor J will substantially diminish his after-tax economic consequences as a result of the allocations. Under the combination of likely investment outcomes least favorable for J, the partnership would realize $550 of tax-exempt interest and $450 of taxable interest and dividends, giving J $492.50 after tax (which is more than the $466.25 after tax J would have received if each of such amounts had been allocated equally between the partners). Under the combination of likely investment outcomes least favorable for I, the partnership would realize $450 of tax-exempt interest and $550 of taxable interest and dividends, giving I $360 after tax (which is not substantially less than the $362.50 he would have received if each of such amounts had been allocated equally between the partners). Accordingly, the allocations in the partnership agreement must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i). In addition, assume that in the first partnership taxable year in which the allocation arrangement described in (i) applies, the partnership realizes $450 of tax-exempt interest and $550 of taxable interest and dividends, so that, pursuant to the partnership agreement, I's capital account is credited with $360 (80 percent of the tax-exempt interest), and J's capital account is credited with $640 (20 percent of the tax-exempt interest and 100 percent of the taxable interest and dividends). The allocations of tax-exempt interest and taxable interest and dividends (which do not have substantial economic effect for the reasons stated in (i) will be disregarded and will be reallocated. Since under the partnership agreement I will receive 36 percent (360/1,000) and J will receive 64 percent (640/1,000) of the partnership's total investment income in such year, under paragraph (b)(3) of this section the partnership's tax-exempt interest and taxable interest and dividends each will be reallocated 36 percent to I and 64 percent to J.

Example (6). K and L are equal partners in a general partnership formed to acquire and operate property described in section 1231(b). The partnership, K, and L have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section). For a taxable year in which the partnership expects to incur a loss on the sale of a portion of such property, the partnership agreement is amended (at the beginning of the taxable year) to allocate such loss to K, who expects to have no gains from the sale of depreciable property described in section 1231(b) in that taxable year, and to allocate an equivalent amount of partnership loss and deduction for that year of a different character to L, who expects to have such gains. Any partnership loss and deduction in excess of these allocations will be allocated equally between K and L. The amendment is effective only for that taxable year. At the time the partnership agreement is amended, there is a strong likelihood that the partnership will incur deduction or loss in the taxable
year other than loss from the sale of property described in section 1231(b) in an amount that will substantially equal or exceed the expected amount of the section 1231(b) loss. The allocations in such taxable year have economic effect. However, the economic effect of the allocations is insubstantial under the test described in paragraph (b)(2)(iii)(b) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that the net increases and decreases to K's and L's capital accounts will be the same at the end of the taxable year to which they apply with such allocations in effect as they would have been in the absence of such allocations, and that the total taxes of K and L for such year will be reduced as a result of such allocations. If in fact the partnership incurs deduction or loss, other than loss from the sale of property described in section 1231(b), in an amount at least equal to the section 1231(b) loss, the loss and deduction in such taxable year will be reallocated equally between K and L under paragraph (b)(3) of this section. If not, the loss from the sale of property described in section 1231(b) and the items of deduction and other loss realized in such year will be reallocated between K and L in proportion to the net decreases in their capital accounts due to the allocation of such items under the partnership agreement.

Example (7). (i) M and N are partners in the MN general partnership, which is engaged in an active business. Income, gain, loss, and deduction from MN's business is allocated equally between M and N. The partnership, M, and N have calendar taxable years. Under the partnership agreement the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). In order to enhance the credit standing of the partnership, the partners contribute surplus funds to the partnership, which the partners agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first 3 taxable years. M is expected to be in a higher marginal tax bracket than N during those 3 years. At the time the decision to make these investments is made, it is agreed that, during the 3-year period of the investment, M will be allocated 90 percent and N 10 percent of the interest income from the tax-exempt bonds as well as any gain or loss from the sale thereof, and that M will be allocated 10 percent and N 90 percent of the dividend income from the corporate stock as well as any gain or loss from the sale thereof. At the time the allocations concerning the investments become part of the partnership agreement, there is not a strong likelihood that the gain or loss from the sale of the stock will be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there is a strong likelihood that the tax-exempt interest and the taxable dividends realized from these investments during the 3-year period will not differ substantially. These allocations have economic effect, and the economic effect of the allocations of the gain or loss on the sale of the tax-exempt bonds and corporate stock is substantial. The economic effect of the allocations of the tax-exempt interest and the taxable dividends, however, is not substantial under the test described in paragraph (b)(2)(iii)(c) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that at the end of the 3-year period to which such allocations relate, the net
increases and decreases to M's and N's capital accounts will be the same with such allocations as they would have been in the absence of such allocations, and that the total taxes of M and N for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the amounts of the tax-exempt interest and taxable dividends earned by the partnership during the 3-year period are equal, the tax-exempt interest and taxable dividends will be reallocated to the partners in equal shares under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts during such 3-year period due to the allocation of such items under the partnership agreement.

(ii) Assume the same facts as in (i) except that gain or loss from the sale of the tax-exempt bonds and corporate stock will be allocated equally between M and N and the partnership agreement provides that the 90/10 allocation arrangement with respect to the investment income applies only to the first $10,000 of interest income from the tax-exempt bonds and the first $10,000 of dividend income from the corporate stock, and only to the first taxable year of the partnership. There is a strong likelihood at the time the 90/10 allocation of the investment income became part of the partnership agreement that in the first taxable year of the partnership, the partnership will earn more than $10,000 of tax-exempt interest and more than $10,000 of taxable dividends. The allocations of tax-exempt interest and taxable dividends provided in the partnership agreement have economic effect, but under the test contained in paragraph (b)(2)(iii)(b) of this section, such economic effect is not substantial for the same reasons stated in (i) (but applied to the 1 taxable year, rather than to a 3-year period). If in fact the partnership realizes at least $10,000 of tax-exempt interest and at least $10,000 of taxable dividends in such year, the allocations of such interest income and dividend income will be reallocated equally between M and N under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts due to the allocations of such items under the partnership agreement.

(iii) Assume the same facts as in (ii) except that at the time the 90/10 allocation of investment income becomes part of the partnership agreement, there is not a strong likelihood that (1) the partnership will earn $10,000 or more of tax-exempt interest and $10,000 or more of taxable dividends in the partnership's first taxable year, and (2) the amount of tax-exempt interest and taxable dividends earned during such year will be substantially the same. Under these facts the economic effect of the allocations generally will be substantial. (Additional facts may exist in certain cases, however, so that the allocation is insubstantial under the second sentence of paragraph (b)(2)(iii). See example (5) above.)

Example (8). (i) O and P are equal partners in the OP general partnership. The partnership, O, and P have calendar taxable years. Partner O has a net operating loss carryover from another venture that is due to expire at the end of the partnership's second taxable year. Otherwise, both partners expect to be in the 50 percent marginal tax bracket in the next several taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest)
will be made in accordance with the partners’ positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(ii)(b) (2) and (3) of this section). The partnership agreement is amended (at the beginning of the partnership’s second taxable year) to allocate all the partnership net taxable income for that year to O. Future partnership net taxable loss is to be allocated to O, and future partnership net taxable income to P, until the allocation of income to O in the partnership’s second taxable year is offset. It is further agreed orally that in the event the partnership is liquidated prior to completion of such offset, O’s capital account will be adjusted downward to the extent of one-half of the allocations of income to O in the partnership’s second taxable year that have not been offset by other allocations, P’s capital account will be adjusted upward by a like amount, and liquidation proceeds will be distributed in accordance with the partners’ adjusted capital account balances. As a result of this oral amendment, all allocations of partnership net taxable income and net taxable loss made pursuant to the amendment executed at the beginning of the partnership’s second taxable year lack economic effect and will be disregarded. Under the partnership agreement other allocations are made equally to O and P, and O and P will share equally in liquidation proceeds, indicating that the partners’ interests in the partnership are equal. Thus, the disregarded allocations will be reallocated equally between the partners under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i) except that there is no agreement that O’s and P’s capital accounts will be adjusted downward and upward, respectively, to the extent of one-half of the partnership net taxable income allocated to O in the partnership’s second taxable year that is not offset subsequently by other allocations. The income of the partnership is generated primarily by fixed interest payments received with respect to highly rated corporate bonds, which are expected to produce sufficient net taxable income prior to the end of the partnership’s seventh taxable year to offset in large part the net taxable income to be allocated to O in the partnership’s second taxable year. Thus, at the time the allocations are made part of the partnership agreement, there is a strong likelihood that the allocation of net taxable income to be made to O in the second taxable year will be offset in large part within 5 taxable years thereafter. These allocations have economic effect. However, the economic effect of the allocation of partnership net taxable income to O in the partnership’s second taxable year, as well as the offsetting allocations to P, is not substantial under the test contained in paragraph (b)(2)(iii)(c) of this section because there is a strong likelihood that the net increases or decreases in O’s and P’s capital accounts will be the same at the end of the partnership’s seventh taxable year with such allocations as they would have been in the absence of such allocations, and the total taxes of O and P for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the partnership, in its taxable years 3 through 7, realizes sufficient net taxable income to offset the amount allocated to O in the second taxable year, the allocations provided in the partnership agreement will be reallocated equally between the partners under paragraph (b)(3) of this section.

Example (9). Q and R form a limited partnership with contributions of $20,000 and $180,000, respectively. Q, the limited partner, is a corporation that has
$2,000,000 of net operating loss carryforwards that will not expire for 8 years. Q does not expect to have sufficient income (apart from the income of the partnership) to absorb any of such net operating loss carryforwards. R, the general partner, is a corporation that expects to be in the 46 percent marginal tax bracket for several years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(iii)(b) (2) and (3) of this section). The partnership's cash, together with the proceeds of an $800,000 loan, are invested in assets that are expected to produce taxable income and cash flow (before debt service) of approximately $150,000 a year for the first 8 years of the partnership's operations. In addition, it is expected that the partnership's total taxable income in its first 8 taxable years will not exceed $2,000,000. The partnership's $150,000 of cash flow in each of its first 8 years will be used to retire the $800,000 loan. The partnership agreement provides that partnership net taxable income will be allocated 90 percent to Q and 10 percent to R in the first through eighth partnership taxable years, and 90 percent to R and 10 percent to Q in all subsequent partnership taxable years. Net taxable loss will be allocated 90 percent to R and 10 percent to Q in all partnership taxable years. All distributions of cash from the partnership to partners (other than the priority distributions to Q described below) will be made 90 percent to R and 10 percent to Q. At the end of the partnership's eighth taxable year, the amount of Q's capital account in excess of one-ninth of R's capital account on such date will be designated as Q's "excess capital account." Beginning in the ninth taxable year of the partnership, the undistributed portion of Q's excess capital account will begin to bear interest (which will be paid and deducted under section 707(c) at a rate of interest below the rate that the partnership can borrow from commercial lenders, and over the next several years (following the eight year) the partnership will make priority cash distributions to Q in prearranged percentages of Q's excess capital account designed to amortize Q's excess capital account and the interest thereon over a prearranged period. In addition, the partnership's agreement prevents Q from causing his interest in the partnership from being liquidated (and thereby receiving the balance in his capital account) without R's consent until Q's excess capital account has been eliminated. The below market rate of interest and the period over which the amortization will take place are prescribed such that, as of the end of the partnership's eighth taxable year, the present value of Q's right to receive such priority distributions is approximately 46 percent of the amount of Q's excess capital account as of such date. However, because the partnership's income for its first 8 taxable years will be realized approximately ratably over that period, the present value of Q's right to receive the priority distributions with respect to its excess capital account is, as of the date the partnership agreement is entered into, less than the present value of the additional Federal income taxes for which R would be liable if, during the partnership's first 8 taxable years, all partnership income were to be allocated 90 percent to R and 10 to Q. The allocations of partnership taxable income to Q and R in the first through eighth partnership taxable years have economic effect. However, such economic effect is not substantial under the general rules set
forth in paragraph (b)(2)(iii) of this section. This is true because R may enhance his after-tax economic consequences, on a present value basis, as a result of the allocations to Q of 90 percent of partnership's income during taxable years 1 through 8, and there is a strong likelihood that neither R nor Q will substantially diminish its after-tax economic consequences, on a present value basis, as a result of such allocation. Accordingly, partnership taxable income for partnership taxable years 1 through 8 will be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

Example (10). (i) S and T form a general partnership to operate a travel agency. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section). The partnership agreement provides that T, a resident of a foreign country, will be allocated 90 percent, and S 10 percent, of the income, gain, loss, and deduction derived from operations conducted by T within his country, and all remaining income, gain, loss, and deduction will be allocated equally. The amount of such income, gain, loss, or deduction cannot be predicted with any reasonable certainty. The allocations provided by the partnership agreement have substantial economic effect.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all income, gain, loss, and deduction of the partnership will be shared equally, but that T will be allocated all income, gain, loss, and deduction derived from operations conducted by him within his country as a part of his equal share of partnership income, gain, loss, and deduction, upon to the amount of such share. Assume the total tax liability of S and T for each year to which these allocations relate will be reduced as a result of such allocation. These allocations have economic effect. However, such economic effect is not substantial under the test stated in paragraph (b)(2)(iii)(b) of this section because, at the time the allocations became part of the partnership agreement, there is a strong likelihood that the net increases and decreases to S's and T's capital accounts will be the same at the end of each partnership taxable year with such allocations as they would have been in the absence of such allocations, and that the total tax liability of S and T for each year to which such allocations relate will be reduced as a result of such allocations. Thus, all items of partnership income, gain, loss, and income, gain, loss, and deduction will be reallocated equally between S and T under paragraph (b)(3) of this section.

Example (11). (i) U and V share equally all income, gain, loss, and deduction of the UV general partnership, as well as all non-liquidating distributions made by the partnership. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section). The
The agreement further provides that the partners will be allocated equal shares of any section 705(a)(2)(B) expenditures of the partnership. In the partnership's first taxable year, it pays qualified first-year wages of $6,000 and is entitled to a $3,000 targeted jobs tax credit under sections 44B and 51 of the Code. Under section 280C the partnership must reduce its deduction for wages paid by the $3,000 credit claimed (which amount constitutes a section 705(a)(2)(B) expenditure). The partnership agreement allocates the credit to U. Although the allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect, the allocation of tax credit cannot have economic effect since it cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section. Under that rule, since the expenses that gave rise to the credit are shared equally by the partners, the credit will be shared equally between U and V.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, the partnership agreement is amended to allocate to U all wage expenses incurred in that year (including wage expenses that constitute section 705(a)(2)(B) expenditures) whether or not such wages qualify for the credit. The partnership agreement contains no offsetting allocations. That taxable year the partnership pays $8,000 in total wages to its employees. Assume that the partnership has operating income equal to its operating expenses (exclusive of expenses for wages). Assume further that $6,000 of the $8,000 wage expense constitutes qualified first-year wages. U is allocated the $3,000 deduction and the $3,000 section 705(a)(2)(B) expenditure attributable to the $6,000 of qualified first-year wages, as well as the deduction for the other $2,000 in wage expenses. The allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect. Furthermore, since the wage credit is allocated in the same proportion as the expenses that gave rise to the credit, and the allocation of those expenses has substantial economic effect, the allocation of such credit to U is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section and is recognized thereunder.

Example (12). (i) W and X form a general partnership for the purpose of mining iron ore. W makes an initial contribution of $75,000, and X makes an initial contribution of $25,000. The partnership agreement provides that non-liquidating distributions will be made 75 percent to W and 25 percent to X, and that all items of income, gain, loss, and deduction will be allocated 75 percent to W and 25 percent to X, except that all percentage depletion deductions will be allocated to W. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraphs (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section). Assume that the adjusted tax basis of the partnership's only depletable iron ore property is $1,000 and that the percentage depletion deduction for the taxable year with respect to such property is $1,500. The allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the
allocation of $1,000 of the percentage depletion deduction have substantial economic effect. The allocation to W of the remaining $500 of the percentage depletion deduction, representing the excess of percentage depletion over adjusted tax basis of the iron ore property, cannot have economic effect since such amount cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation to W of that $500 excess percentage depletion deduction is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section, under which such $500 excess depletion deduction (and all further percentage depletion deductions from the mine) will be reallocated 75 percent to W and 25 percent to X.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all percentage depletion deductions of the partnership will be allocated 75 percent to W and 25 percent to X. Once again, the allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. Furthermore, since the $500 portion of the percentage depletion deduction that exceeds the adjusted basis of such iron ore property is allocated in the same manner as valid allocations of the gross income from such property during the taxable year (i.e., 75 percent to W and 25 percent to X), the allocation of the $500 excess percentage depletion contained in the partnership agreement is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section.

Example (13). (i) Y and Z form a brokerage general partnership for the purpose of investing and trading in marketable securities. Y contributes cash of $10,000, and Z contributes securities of P corporation, which have an adjusted basis of $3,000 and a fair market value of $10,000. The partnership would not be an investment company under section 351(e) if it were incorporated. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section). The partnership uses the interim closing of the books method for purposes of section 706. The initial capital accounts of Y and Z are fixed at $10,000 each. The agreement further provides that all partnership distributions, income, gain, loss, deduction, and credit will be shared equally between Y and Z, except that the taxable gain attributable to the precontribution appreciation in the value of the securities of P corporation will be allocated to Z in accordance with section 704(c). During the partnership's first taxable year, it sells the securities of P corporation for $12,000, resulting in a $2,000 book gain ($12,000 less $10,000 book value) and a $9,000 taxable gain ($12,000 less $3,000 adjusted tax basis). The partnership has no other income, gain, loss, or deductions for the taxable year. The gain from the sale of the securities is allocated as follows:

______ Y _______ Z _______.
<table>
<thead>
<tr>
<th></th>
<th>Tax</th>
<th>Book</th>
<th>Tax</th>
<th>Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account upon formation</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$3,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Plus: gain</td>
<td>1,000</td>
<td>1,000</td>
<td>8,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Capital account at end of year 1</td>
<td>$11,000</td>
<td>$11,000</td>
<td>$11,000</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

The allocation of the $2,000 book gain, $1,000 each to Y and Z, has substantial economic effect. Furthermore, under section 704(c) the partners' distributive shares of the $9,000 taxable gain are $1,000 to Y and $8,000 to Z.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, it invests its $22,000 of cash in securities of G Corp. The G Corp. securities increase in value to $40,000, at which time Y sells 50 percent of his partnership interest (i.e., a 25 percent interest in the partnership) to LK for $10,000. The partnership does not have a section 754 election in effect for the partnership taxable year during which such sale occurs. In accordance with paragraph (b)(2)(iv)(l) of this section, the partnership agreement provides that LK inherits 50 percent of Y's $11,000 capital account balance. Thus, following the sale, LK and Y each have a capital account of $5,500, and Z's capital account remains at $11,000. Prior to the end of the partnership's second taxable year, the securities are sold for their $40,000 fair market value, resulting in an $18,000 taxable gain ($40,000 less $22,000 adjusted tax basis). The partnership has no other income, gain, loss, or deduction in such taxable year. Under the partnership agreement the $18,000 taxable gain is allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Y</th>
<th>Z</th>
<th>LK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account before sale of securities</td>
<td>$5,500</td>
<td>$11,000</td>
<td>$5,500</td>
</tr>
<tr>
<td>Plus: gain</td>
<td>4,500</td>
<td>9,000</td>
<td>4,500</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

The allocation of the $18,000 taxable gain has substantial economic effect.

(iii) Assume the same facts as in (ii) except that the partnership has a section 754 election in effect for the partnership taxable year during which Y sells 50 percent of his interest to LK. Accordingly, under section 1.743-1 there is a $4,500 basis increase to the G Corp. securities with respect to LK. Notwithstanding this basis adjustment, as a result of the sale of the G Corp. securities, LK's capital account is, as in (ii), increased by $4,500. The fact that LK recognizes no taxable gain from such sale (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(m)(2) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(iv) Assume the same facts as in (iii) except that immediately following Y's sale of 50 percent of this interest to LK, the G Corp. securities decrease in value to $32,000 and are sold. The $10,000 taxable gain ($32,000 less $22,000 adjusted tax basis) is allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Y</th>
<th>Z</th>
<th>LK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account before sale of securities</td>
<td>$5,500</td>
<td>$11,000</td>
<td>$5,500</td>
</tr>
</tbody>
</table>
The fact that LK recognizes a $2,000 taxable loss from the sale of the G Corp. securities (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(m)(2) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(v) Assume the same facts as in (ii) except that Y sells 100 percent of his partnership interest (i.e., a 50 percent interest in the partnership) to LK for $20,000. Under section 708(b)(1)(B) the partnership terminates. Under paragraph (b)(1)(iv) of section 1.708-1, there is a constructive liquidation of the partnership. Immediately preceding the constructive liquidation, the capital accounts of Z and LK equal $11,000 each (LK having inherited Y's $11,000 capital account) and the book value of the G Corp. securities is $22,000 (original purchase price of securities). Under paragraph (b)(2)(iv)(l) of this section, the deemed contribution of assets and liabilities by the terminated partnership to the new partnership and the deemed liquidation of the terminated partnership that occur under section 1.708-1(b)(1)(iv) in connection with the constructive liquidation of the terminated partnership are disregarded in the maintenance and computation of the partners' capital accounts. As a result, the capital accounts of Z and LK in the new partnership equal $11,000 each (their capital accounts in the terminated partnership immediately prior to the termination), and the book value of the G Corp. securities remains $22,000 (its book value immediately prior to the termination). This Example 13(v) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this Example 13(v) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this Example 13(v) to the termination in a consistent manner.

Example (14). (i) MC and RW form a general partnership to which each contributes $10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market). In each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding gain or loss from the sale of securities). The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership uses the interim closing of the books method for purposes of section 706. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward (to $25,000 each) to reflect their
shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

<table>
<thead>
<tr>
<th></th>
<th>MC</th>
<th>RW</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account following SK's admission</td>
<td>Tax</td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Plus: gain</td>
<td>15,000</td>
<td>0</td>
<td>15,000</td>
</tr>
<tr>
<td>Capital account following sale</td>
<td>$25,000</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

(ii) Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

<table>
<thead>
<tr>
<th></th>
<th>MC</th>
<th>RW</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account following SK's admission</td>
<td>Tax</td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Plus: gain</td>
<td>23,000</td>
<td>8,000</td>
<td>23,000</td>
</tr>
<tr>
<td>Capital account following sale</td>
<td>$33,000</td>
<td>$33,000</td>
<td>$33,000</td>
</tr>
</tbody>
</table>

(iii) Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are
sold, resulting in taxable gain of $24,000 ($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

<table>
<thead>
<tr>
<th>Capital account following SK's admission</th>
<th>MC</th>
<th>RW</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Book</td>
<td>$25,000</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Plus: gain</td>
<td>12,000</td>
<td>12,000</td>
<td>0</td>
</tr>
<tr>
<td>Less: loss</td>
<td>0</td>
<td>(2,000)</td>
<td>0</td>
</tr>
<tr>
<td>Capital account following sale</td>
<td>$22,000</td>
<td>$23,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

That SK bears an economic loss of $2,000 without a corresponding taxable loss is attributable entirely to the "ceiling rule." See paragraph (c)(2) of section 1.704-1.

(iv) Assume the same facts as in (ii) except that upon the admission of SK the capital accounts of MC and RW are not each adjusted upward from $10,000 to $25,000 to reflect the appreciation in the partnership's securities that occurred before SK was admitted to the partnership. Rather, upon SK's admission to the partnership, the partnership agreement is amended to provide that the first $30,000 of taxable gain upon the sale of such securities will be allocated equally between MC and RW, and that all other income, gain, loss, and deduction will be allocated equally between MC, RW, and SK. When the securities are sold for $74,000, the $54,000 of taxable gain is so allocated. These allocations of taxable gain have substantial economic effect. (If the agreement instead provides for all taxable gain (including the $30,000 taxable gain attributable to the appreciation in the securities prior to SK's admission to the partnership) to be allocated equally between MC, RW, and SK, the partners should consider whether, and to what extent, the provisions of paragraphs (b)(1) (iii) and (iv) of this section are applicable.)

(v) Assume the same facts as in (iv) except that instead of selling the securities, the partnership makes a distribution of the securities (which have a fair market value of $74,000). Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). In accordance with paragraph (b)(2)(iv)(e) of this section, the partners' capital accounts are adjusted immediately prior to the distribution to reflect how taxable gain ($54,000) would have been allocated had the securities been sold for their $74,000 fair market value, and capital account
adjustments in respect of the distribution of the securities are made with reference to the $74,000 "booked-up" fair market value.

(vi) Assume the same facts as in (i) except that the partnership does not sell the Ventureco securities. During the next 3 years the fair market value of the Ventureco securities remains at $50,000, and the partnership engages in no other investment activities. Thus, at the end of that period the balance sheet of the partnership and the partners' capital accounts are the same as they were at the beginning of such period. At the end of the 3 years, MC's interest in the partnership is liquidated for the $25,000 cash held by the partnership. Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). Assume further that the partnership has a section 754 election in effect for the taxable year during which such liquidation occurs. Under sections 734(b) and 755 the partnership increases the basis of the Ventureco securities by the $15,000 basis adjustment (the excess of $25,000 over the $10,000 adjusted tax basis of MC's partnership interest).

<table>
<thead>
<tr>
<th></th>
<th>MC</th>
<th>RW</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account before adjustment</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Deemed sale adjustment</td>
<td>23,000</td>
<td>23,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Less: distribution</td>
<td>(24,667)</td>
<td>(24,667)</td>
<td>(24,667)</td>
</tr>
<tr>
<td>Capital account after distribution</td>
<td>$8,333</td>
<td>$8,333</td>
<td>$8,333</td>
</tr>
</tbody>
</table>

(vii) Assume the same facts as in (vi) except that the partnership has no section 754 election in effect for the taxable year during which such liquidation occurs.

<table>
<thead>
<tr>
<th></th>
<th>MC</th>
<th>RW</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account before distribution</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Less: distribution</td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>0</td>
</tr>
<tr>
<td>Capital account after liquidation</td>
<td>($15,000)</td>
<td>0</td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Following the liquidation of MC’s interest in the partnership, the Ventureco securities are sold for their $50,000 fair market value, resulting in no book gain or loss but a $30,000 taxable gain. An allocation of this $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners’ book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners’ interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that $15,000 of such taxable gain will, in accordance with section 704(c) principles, be included in RW’s distributive share, the partners’ capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section. The remaining $15,000 of such gain will, under paragraph (b)(3) of this section, be shared equally between RW and SK.

Example (15). (i) JB and DK form a limited partnership for the purpose of purchasing residential real estate to lease. JB, the limited partner, contributes $13,500, and DK, the general partner, contributes $1,500. The partnership, which uses the cash receipts and disbursements method of accounting, purchases a building for $100,000 (on leased land), incurring a recourse mortgage of $85,000 that requires the payment of interest only for a period of 3 years. The partnership agreement provides that partnership net taxable income and loss will be allocated 90 percent to JB and 10 percent to DK, the partners’ capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner’s interest) will be made in accordance with the partners’ positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section), and JB is not required to restore any deficit balance in his capital account, but DK is so required. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section). As of the end of each of the partnership’s first 3 taxable years, the items described in paragraphs (b)(2)(ii)(d)(4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in JB’s capital account. In the partnership’s first taxable year, it has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership’s first taxable year.

<table>
<thead>
<tr>
<th></th>
<th>JB</th>
<th>DK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account upon formation</td>
<td>$13,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Less: year 1 net loss</td>
<td>(10,800)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Capital account at end of year 1</td>
<td>$2,700</td>
<td>$300</td>
</tr>
</tbody>
</table>

The alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section is satisfied as of the end of the partnership’s first taxable year. Thus, the allocation made in the partnership’s first taxable year has economic effect.

(ii) Assume the same facts as in (i) and that in the partnership’s second taxable year it again has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200,
respectively, of the $12,000 net taxable loss incurred in the partnership's second taxable year.

<table>
<thead>
<tr>
<th></th>
<th>JB</th>
<th>DK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at beginning of year 1</td>
<td>$2,700</td>
<td>$300</td>
</tr>
<tr>
<td>Less: year 2 net loss</td>
<td>(10,800)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>($8,100)</td>
<td>($900)</td>
</tr>
</tbody>
</table>

Only $2,700 of the $10,800 net taxable loss allocated to JB satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section as of the end of the partnership's second taxable year. The allocation of such $2,700 net taxable loss to JB (consisting of $2,250 of rental income, $450 of operating expenses, $1,800 of interest expense, and $2,700 of cost recovery deductions) has economic effect. The remaining $8,100 of net taxable loss allocated by the partnership agreement to JB must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, the determination of the partners' interests in the remaining $8,100 net taxable loss is made by comparing how distributions (and contributions) would be made if the partnership sold its property at its adjusted tax basis and liquidated immediately following the end of the partnership's first taxable year with the results of such a sale and liquidation immediately following the end of the partnership's second taxable year. If the partnership's real property were sold for its $88,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's first taxable year, the $88,000 sales proceeds would be used to repay the $85,000 note, and there would be $3,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $300 and $2,700, respectively. If such property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining in the partnership to distribute. A comparison of these outcomes indicates that JB bore $2,700 and DK $9,300 of the economic burden that corresponds to the $12,000 net taxable loss. Thus, in addition to the $1,200 net taxable loss allocated to DK under the partnership agreement, $8,100 of net taxable loss will be reallocated to DK under paragraph (b)(3)(iii) of this section. Similarly, for subsequent taxable years, absent an increase in JB's capital account, all net taxable loss allocated to JB under the partnership agreement will be reallocated to DK.

(iii) Assume the same facts as in (ii) and that in the partnership's third taxable year there is rental income of $35,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $10,000. The capital accounts of the partners maintained on the books of the partnership do not take into account the reallocation to DK of the $8,100 net taxable loss in the partnership's second taxable year. Thus, an allocation of the $15,000 net taxable income $13,500 to JB and $1,500 to DK (as dictated by the partnership agreement and as reflected in the capital accounts of the partners) does not have economic effect. The partners' interests in the partnership with respect to
such $15,000 taxable gain again is made in the manner described in paragraph (b) (3) (iii) of this section. If the partnership's real property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining to distribute. If such property were sold for its $66,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's third taxable year, the $91,000 ($66,000 sales proceeds plus $25,000 cash on hand) would be used to repay the $85,000 note and there would be $6,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $600 and $5,400, respectively. Accordingly, under paragraph (b) (3) (iii) of this section the $15,000 net taxable income in the partnership's third taxable year will be reallocated $9,600 to DK (minus $9,000 at end of the second taxable year to positive $600 at end of the third taxable year) and $5,400 to JB (zero at end of the second taxable year to positive $5,400 at end of the third taxable year).

Example (16). (i) KG and WN form a limited partnership for the purpose of investing in improved real estate. KG, the general partner, contributes $10,000 to the partnership, and WN, the limited partner, contributes $990,000 to the partnership. The $1,000,000 is used to purchase an apartment building on leased land. The partnership agreement provides that (1) the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section; (2) cash will be distributed first to WN until such time as he has received the amount of his original capital contribution ($990,000), next to KG until such time as he has received the amount of his original capital contribution ($10,000), and thereafter equally between WN and KG; (3) partnership net taxable income will be allocated 99 percent to WN and 1 percent to KG until the cumulative net taxable income allocated for all taxable years is equal to the cumulative net taxable loss previously allocated to the partners, and thereafter equally between WN and KG; (4) partnership net taxable loss will be allocated 99 percent to WN and 1 percent to KG, unless net taxable income has previously been allocated equally between WN and KG, in which case such net taxable loss first will be allocated equally until the cumulative net taxable loss allocated for all taxable years is equal to the cumulative net taxable income previously allocated to the partners; and (5) upon liquidation, WN is not required to restore any deficit balance in his capital account, but KG is so required. Since distributions in liquidation are not required to be made in accordance with the partners' positive capital account balances, and since WN is not required, upon the liquidation of his interest, to restore the deficit balance in his capital account to the partnership, the allocations provided by the partnership agreement do not have economic effect and will be reallocated in accordance with the partners' interests in the partnership under paragraph (b) (3) of this section.

(ii) Assume the same facts as in (i) except that the partnership agreement further provides that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(iii)(d) (4), (5),

Example (16). (i) KG and WN form a limited partnership for the purpose of investing in improved real estate. KG, the general partner, contributes $10,000 to the partnership, and WN, the limited partner, contributes $990,000 to the partnership. The $1,000,000 is used to purchase an apartment building on leased land. The partnership agreement provides that (1) the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section; (2) cash will be distributed first to WN until such time as he has received the amount of his original capital contribution ($990,000), next to KG until such time as he has received the amount of his original capital contribution ($10,000), and thereafter equally between WN and KG; (3) partnership net taxable income will be allocated 99 percent to WN and 1 percent to KG until the cumulative net taxable income allocated for all taxable years is equal to the cumulative net taxable loss previously allocated to the partners, and thereafter equally between WN and KG; (4) partnership net taxable loss will be allocated 99 percent to WN and 1 percent to KG, unless net taxable income has previously been allocated equally between WN and KG, in which case such net taxable loss first will be allocated equally until the cumulative net taxable loss allocated for all taxable years is equal to the cumulative net taxable income previously allocated to the partners; and (5) upon liquidation, WN is not required to restore any deficit balance in his capital account, but KG is so required. Since distributions in liquidation are not required to be made in accordance with the partners' positive capital account balances, and since WN is not required, upon the liquidation of his interest, to restore the deficit balance in his capital account to the partnership, the allocations provided by the partnership agreement do not have economic effect and will be reallocated in accordance with the partners' interests in the partnership under paragraph (b) (3) of this section.

(ii) Assume the same facts as in (i) except that the partnership agreement further provides that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(iii)(d) (4), (5),
and (6) of this section are not reasonably expected to cause or increase a deficit balance in WN's capital account. The allocations provided by the partnership agreement have economic effect.

**Example (17).** FG and RP form a partnership with FG contributing cash of $100 and RP contributing property, with 2 years of cost recovery deductions remaining, that has an adjusted tax basis of $80 and a fair market value of $100. The partnership, FG, and RP have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, liquidation proceeds will be made in accordance with capital account balances, and each partner is liable to restore the deficit balance in his capital account to the partnership upon liquidation of his interest (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section). FG expects to be in a substantially higher tax bracket than RP in the partnership's first taxable year. In the partnership's second taxable year, and in subsequent taxable years, it is expected that both will be in approximately equivalent tax brackets. The partnership agreement allocates all items equally except that all $50 of book depreciation is allocated to FG in the partnership's first taxable year and all $50 of book depreciation is allocated to RP in the partnership's second taxable year. If the allocation to FG of all book depreciation in the partnership's first taxable year is respected, FG would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. Likewise, if the allocation to RP of all the book depreciation in the partnership's second taxable year is respected, RP would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. The allocation of book depreciation to FG and RP in the partnership's first 2 taxable years has economic effect within the meaning of paragraph (b)(2)(ii) of this section. However, the economic effect of these allocations is not substantial under the test described in paragraph (b)(2)(iii)(c) of this section since there is a strong likelihood at the time such allocations became part of the partnership agreement that at the end of the 2-year period to which such allocations relate, the net increases and decreases to FG's and RP's capital accounts will be the same with such allocations as they would have been in the absence of such allocation, and the total tax liability of FG and RP for the taxable years to which the section 704(c) determinations relate would be reduced as a result of the allocations of book depreciation. As a result the allocations of book depreciation in the partnership agreement will be disregarded. FG and RP will be allocated such book depreciation in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts the book depreciation deductions will be reallocated equally between the partners, and section 704(c) will be applied with reference to such reallocation of book depreciation.

**Example (18).** (i) WM and JL form a general partnership by each contributing $300,000 thereto. The partnership uses the $600,000 to purchase an item of tangible personal property, which it leases out. The partnership elects under section 48 (q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that (1) the partners' capital account will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, (2) distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the
partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section), (3) any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(3) of this section), (4) all income, gain, loss, and deduction of the partnership will be allocated equally between the partners, and (5) all non-liquidating distributions of the partnership will be made equally between the partners. Assume that in each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding cost recovery and depreciation deductions and gain or loss on the sale of its property). During its first 2 taxable years, the partnership has an additional $200,000 cost recovery deduction in each year. Pursuant to the partnership agreement these items are allocated equally between WM and JL.

<table>
<thead>
<tr>
<th>Capital account upon formation</th>
<th>WM</th>
<th>JL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: net loss for years 1 and 2</td>
<td>(200,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

The allocations made in the partnership's first 2 taxable years have substantial economic effect.

(ii) Assume the same facts as in (i) and that MK is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of his admission, the fair market value of the partnership property is $600,000. MK contributes $300,000 to the partnership in exchange for an equal one-third interest in the partnership, and, as permitted under paragraph (b)(2)(iv)(g), the capital accounts of WM and JL are adjusted upward to $300,000 each to reflect the fair market value of partnership property. In addition, the partnership agreement is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the partnership property that appreciated prior to MK's admission will be shared among the partners in a manner that takes account of the variation between such property's $200,000 adjusted tax basis and its $600,000 book value in accordance with paragraph (b)(2)(iv)(f) and the special rule contained in paragraph (b)(4)(i) of this section. Depreciation and gain or loss, as computed for book purposes, with respect to such property will be allocated equally among the partners and, in accordance with paragraph (b)(2)(iv)(g) of this section, will be reflected in the partner's capital accounts, as will all other partnership income, gain, loss, and deduction. Since the requirements of (b)(2)(iv)(g) of this section are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with paragraph (B)(2)(iv) of this section.

(iii) Assume the same facts as in (ii) and that immediately after MK's admission to the partnership, the partnership property is sold for $600,000, resulting in a taxable gain of $400,000 ($600,000 less $200,000 adjusted tax basis) and no book gain or loss, and the partnership is liquidated. An allocation of the $400,000 taxable gain cannot have economic effect because such gain cannot properly be reflected in the partners' book capital accounts. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $400,000 taxable gain will,
in accordance with section 704(c) principles, be shared equally between WM and JL.

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th></th>
<th>JL</th>
<th></th>
<th>MK</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>at beginning of</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>year 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plus: gain</td>
<td>200,000</td>
<td>0</td>
<td>200,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Capital account</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>before liquidation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The $900,000 of partnership cash ($600,000 sales proceeds plus $300,000 contributed by MK) is distributed equally among WM, JL, and MK in accordance with their adjusted positive capital account balances, each of which is $300,000.

(iv) Assume the same facts as in (iii) except that prior to liquidation the property appreciates and is sold for $900,000, resulting in a taxable gain of $700,000 ($900,000 less $200,000 adjusted tax basis) and a book gain of $300,000 ($900,000 less $600,000 book value). Under the partnership agreement the $300,000 of book gain is allocated equally among the partners, and such allocation has substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th></th>
<th>JL</th>
<th></th>
<th>MK</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>at beginning of</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>year 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plus: gain</td>
<td>300,000</td>
<td>100,000</td>
<td>300,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital account</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>before liquidation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $700,000 taxable gain is, in accordance with section 704(c) principles, shared $300,000 to JL, $300,000 to WM, and $100,000 to MK. This ensures that (1) WM and JL share equally the $400,000 taxable gain that is attributable to appreciation in the property that occurred prior to MK's admission to the partnership in the same manner as it was reflected in their capital accounts upon MK's admission, and (2) WM, JL, and MK share equally the additional $300,000 taxable gain in the same manner as they shared the $300,000 book gain.

(v) Assume the same facts as in (ii) except that shortly after MK's admission the property depreciates and is sold for $450,000, resulting in a taxable gain of $250,000 ($450,000 less $200,000 adjusted tax basis) and a book loss of $150,000 ($450,000 less $600,000 book value). Under the partnership agreement these items are allocated as follow:
### Capital account at beginning of year 3

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th>JL</th>
<th>MK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Book</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th>JL</th>
<th>MK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus: gain</td>
<td>125,000</td>
<td>0</td>
<td>125,000</td>
</tr>
<tr>
<td>Less: loss</td>
<td>0</td>
<td>(50,000)</td>
<td>0</td>
</tr>
<tr>
<td>Capital account before liquidation</td>
<td>$225,000</td>
<td>$250,000</td>
<td>$225,000</td>
</tr>
</tbody>
</table>

The $150,000 book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $250,000 taxable gain is, in accordance with section 704(c) principles, shared equally between WM and JL. The fact that MK bears an economic loss of $50,000 without a corresponding taxable loss is attributable entirely to the "ceiling rule." See paragraph (c)(2) of section 1.704-1.

(vi) Assume the same facts as in (ii) except that the property depreciates and is sold for $170,000, resulting in a $30,000 taxable loss ($200,000 adjusted tax basis less $170,000) and a book loss of $430,000 ($600,000 book value less $170,000). The book loss of $430,000 is allocated equally among the partners ($143,333 each) and has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the entire $30,000 taxable loss is, in accordance with section 704(c) principles, included in MK's distributive share.

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th>JL</th>
<th>MK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Book</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th>JL</th>
<th>MK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: loss</td>
<td>0</td>
<td>(143,333)</td>
<td>0</td>
</tr>
<tr>
<td>Capital account before liquidation</td>
<td>$100,000</td>
<td>$156,667</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

(vii) Assume the same facts as in (ii) and that during the partnership's third taxable year, the partnership has an additional $100,000 cost recovery deduction and $300,000 book depreciation deduction attributable to the property purchased by the partnership in its first taxable year. The $300,000 book depreciation deduction is allocated equally among the partners, and that allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction for the partnership's third taxable year is, in accordance with section 704(c) principles,
included in MK’s distributive share. This is because under these facts those principles require MK to include the cost recovery deduction for such property in his distributive share up to the amount of the book depreciation deduction for such property properly allocated to him.

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th></th>
<th>JL</th>
<th></th>
<th>MK</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>at beginning of year 3</td>
<td>0</td>
<td>(100,000)</td>
<td>0</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>recovery/depreciation deduction for year 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>$100,000</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

(viii) Assume the same facts as in (vii) except that upon MK’s admission the partnership property has an adjusted tax basis of $220,000 (instead of $200,000), and thus the cost recovery deduction for the partnership’s third taxable year is $110,000. Assume further that upon MK’s admission WM and JL have adjusted capital account balances of $110,000 and $100,000, respectively. Consistent with the special partners’ interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the excess $10,000 cost recovery deduction ($110,000 less $100,000 included in MK’s distributive share) is, in accordance with section 704(c) principles, shared equally between WM and JL and is so included in their respective distributive shares for the partnership’s third taxable year.

(ix) Assume the same facts as in (vii) except that upon MK’s admission the partnership agreement is amended to allocate the first $400,000 of book depreciation and loss on partnership property equally between WM and JL and the last $200,000 of such book depreciation and loss to MK. Assume such allocations have substantial economic effect. Pursuant to this amendment the $300,000 book depreciation deduction in the partnership’s third taxable year is allocated equally between WM and JL. Consistent with the special partners’ interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction is, in accordance with section 704(c) principles, shared equally between WM and JL. In the partnership’s fourth taxable year, it has a $60,000 cost recovery deduction and a $180,000 book depreciation deduction. Under the amendment described above, the $180,000 book depreciation deduction is allocated $50,000 to WM, $50,000 to JL, and $80,000 to MK. Consistent with the special partners’ interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction is, in accordance with section 704(c) principles, included entirely in MK’s distributive share.
at beginning of year 3
Less:
(a) recovery/depreciation deduction for year 3
   (50,000) (150,000) (50,000) (150,000) 0 0
(b) recovery/depreciation deduction for year 4
   0 (50,000) 0 (50,000) (60,000) (80,000)
Capital account at end of year 4
$50,000 $100,000 $50,000 $100,000 $240,000 $220,000

(x) Assume the same facts as in (vii) and that at the beginning of the partnership's third taxable year, the partnership purchases a second item of tangible personal property for $300,000 and elects under section 48(q) (4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement is amended to allocate the first $150,000 of cost recovery deductions and loss from such property to WM and the next $150,000 of cost recovery deductions and loss from such property equally between JL and MK. Thus, in the partnership's third taxable year it has, in addition to the items specified in (vii), a cost recovery and book depreciation deduction of $100,000 attributable to the newly acquired property, which is allocated entirely to WM.

As in (vii), the allocation of the $300,000 book depreciation attributable to the property purchased in the partnership's first taxable year equally among the partners has substantial economic effect, and consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement properly provides for the entire $100,000 cost recovery deduction attributable to such property to be included in MK's distributive share. Furthermore, the allocation to WM of the $100,000 cost recovery deduction attributable to the property purchased in the partnership's third taxable year has substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>WM Tax</th>
<th>WM Book</th>
<th>JL Tax</th>
<th>JL Book</th>
<th>MK Tax</th>
<th>MK Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at beginning of year 3</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Less: (a) recovery/depreciation deduction for property bought in year 1</td>
<td>0</td>
<td>(100,000)</td>
<td>0</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>(b) recovery/depreciation deduction</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
(xi) Assume the same facts as in (x) and that at the beginning of the partnership’s fourth taxable year, the properties purchased in the partnership’s first and third taxable years are disposed of for $90,000 and $180,000, respectively, and the partnership is liquidated. With respect to the property purchased in the first taxable year, there is a book loss of $210,000 ($300,000 book value less $90,000) and a taxable loss of $10,000 ($100,000 adjusted tax basis less $90,000). The book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners’ interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the taxable loss of $10,000 will, in accordance with section 704(c) principles, be included entirely in MK’s distributive share. With respect to the property purchased in the partnership’s third taxable year, there is a book and taxable loss of $20,000. Pursuant to the partnership agreement this loss is allocated entirely to WM, and such allocation has substantial economic effect.

<table>
<thead>
<tr>
<th>WM</th>
<th>JL</th>
<th>MK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>$0</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>(a) loss on property bought in year 1</td>
<td>0</td>
<td>(70,000)</td>
</tr>
<tr>
<td>(b) loss on property bought in year 3</td>
<td>(20,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Capital account before liquidation</td>
<td>($20,000)</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Partnership liquidation proceeds ($270,000) are properly distributed in accordance with the partners’ adjusted positive book capital account balances ($10,000 to WM, $130,000 to JL and $130,000 to MK).

(xii) Assume the same facts as in (x) and that in the partnership’s fourth taxable year it has a cost recovery deduction of $60,000 and book depreciation deduction of $180,000 attributable to the property purchased in the partnership’s first taxable year, and a cost recovery and book depreciation deduction of $100,000 attributable to the property purchased in the partnership’s third taxable year. The $180,000 book depreciation deduction attributable to the property purchased in the partnership’s first taxable year is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners’ interests in the partnership rule contained in paragraph
(b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction attributable to the property purchased in the first taxable year is, in accordance with section 704(c) principles, included entirely in MK's distributive share. Furthermore, the $100,000 cost recovery deduction attributable to the property purchased in the third taxable year is allocated $50,000 to WM, $25,000 to JL, and $25,000 to MK, and such allocation has substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th></th>
<th>JL</th>
<th></th>
<th>MK</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at beginning of year 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>$0</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Book</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: (a) recovery/depreciation deduction for property bought in year 1</td>
<td>0</td>
<td>(60,000)</td>
<td>0</td>
<td>(60,000)</td>
<td>0</td>
<td>(60,000)</td>
</tr>
<tr>
<td>(b) recovery/depreciation deduction for property bought in year 3</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Capital account at end of year 4</td>
<td>($50,000)</td>
<td>($10,000)</td>
<td>$75,000</td>
<td>$115,000</td>
<td>$115,000</td>
<td>$115,000</td>
</tr>
</tbody>
</table>

At the end of the partnership's fourth taxable year the adjusted tax bases of the partnership properties acquired in its first and third taxable years are $40,000 and $100,000, respectively. If the properties are disposed of at the beginning of the partnership's fifth taxable year for their adjusted tax bases, there would be no taxable gain or loss, a book loss of $80,000 on the property purchased in the partnership's first taxable year ($120,000 book value less $40,000), and cash available for distribution of $140,000.

<table>
<thead>
<tr>
<th></th>
<th>WM</th>
<th></th>
<th>JL</th>
<th></th>
<th>MK</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at beginning of year 5</td>
<td>($50,000)</td>
<td>($10,000)</td>
<td>$75,000</td>
<td>$115,000</td>
<td>$115,000</td>
<td>$115,000</td>
</tr>
<tr>
<td>Less: loss</td>
<td>0</td>
<td>(26,667)</td>
<td>0</td>
<td>(26,667)</td>
<td>0</td>
<td>(26,667)</td>
</tr>
<tr>
<td>Capital account before liquidation</td>
<td>($50,000)</td>
<td>($36,667)</td>
<td>$75,000</td>
<td>$88,333</td>
<td>$115,000</td>
<td>$88,333</td>
</tr>
</tbody>
</table>

If the partnership is then liquidated, the $140,000 of cash on hand plus the $36,667 balance that WM would be required to contribute to the partnership (the deficit balance in his book capital account) would be distributed equally between
JL and MK in accordance with their adjusted positive book capital account balances.

(xiii) Assume the same facts as in (i). Any tax preferences under section 57(a)(12) attributable to the partnership's cost recovery deductions in the first 2 taxable years will be taken into account equally by WM and JL. If the partnership agreement instead provides that the partnership's cost recovery deductions in its first 2 taxable years are allocated 25 percent to WM and 75 percent to JL (and such allocations have substantial economic effect), the tax preferences attributable to such cost recovery deductions would be taken into account 25 percent by WM and 75 percent by JL. The conclusion in the previous sentence is unchanged even if the partnership's operating expenses (exclusive of cost recovery and depreciation deductions) exceed its operating income in each of the partnership's first 2 taxable years, the resulting net loss is allocated entirely to WM, and the cost recovery deductions are allocated 25 percent to WM and 75 percent to JL (provided such allocations have substantial economic effect). If the partnership agreement instead provides that all income, gain, loss, and deduction (including cost recovery and deprecations) are allocated equally between JL and WM, the tax preferences attributable to the cost recovery deductions would be taken into account equally by JL and WM. In this case, if the partnership has a $100,000 cost recovery deduction in its first taxable year and an additional net loss of $100,000 in its first taxable year (i.e., its operating expenses exceed its operating income by $100,000) and purports to categorize JL's $100,000 distributive share of partnership loss as being attributable to the cost recovery deduction and WM's $100,000 distributive share of partnership loss as being attributable to the net loss, the economic effect of such allocations is not substantial, and each partner will be allocated one-half of all partnership income, gain, loss, and deduction and will take into account one-half of the tax preferences attributable to the cost recovery deductions.

Example (19). (i) DG and JC form a general partnership for the purpose of drilling oil wells. DG contributes an oil lease, which has a fair market value and adjusted tax basis of $100,000. JC contributes $100,000 in cash, which is used to finance the drilling operations. The partnership agreement provides that DG is credited with a capital account of $100,000, and JC is credited with a capital account of $100,000. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (2) and (3) of this section. The partnership chooses to adjust capital accounts on a simulated cost depletion basis and elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the basis of its section 38 property. The agreement further provides that (1) all additional cash requirements of the partnership will be borne equally by DG and JC, (2) the deductions attributable to the property (including money) contributed by each partner will be allocated to such partner, (3) all other income, gain, loss, and deductions (and item thereof) will be allocated equally between DG and JC, and (4) all cash from operations will be distributed equally between DG and JC. In the partnership's first taxable year $80,000 of
partnership intangible drilling cost deductions and $20,000 of cost recovery deductions on partnership equipment are allocated to JC, and the $100,000 basis of the lease is, for purposes of the depletion allowance under sections 611 and 613A(c)(7)(D), allocated to DG. The allocations of income, gain, loss, and deduction provided in the partnership agreement have substantial economic effect. Furthermore, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(iv)(k) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the $100,000 adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital for purposes of section 613A(c)(7)(D).

(ii) Assume the same facts as in (i) except that the partnership agreement provides that (1) all additional cash requirements of the partnership for additional expenses will be funded by additional contributions from JC, (2) all cash from operations will first be distributed to JC until the excess of such cash distributions over the amount of such additional expense equals his initial $100,000 contributions, (3) all deductions attributable to such additional operating expenses will be allocated to JC, and (4) all income will be allocated to JC until the aggregate amount of income allocated to him equals the amount of partnership operating expenses funded by his initial $100,000 contribution plus the amount of additional operating expenses paid from contributions made solely by him. The allocations of income, gain, loss, and deduction provided in partnership agreement have economic effect. In addition, the economic effect of the allocations provided in the agreement is substantial. Because the partnership's drilling activities are sufficiently speculative, there is not a strong likelihood at the time the disproportionate allocations of loss and deduction to JC are provided for by the partnership agreement that the economic effect of such allocations will be largely offset by allocations of income. In addition, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(iv)(k) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D).

(iii) Assume the same facts as in (i) except that all distributions, including those made upon liquidation of the partnership, will be made equally between DG and JC, and no partner is obligated to restore the deficit balance in his capital account to the partnership following the liquidation of his interest for distribution to partners with positive capital account balances. Since liquidation proceeds will be distributed equally between DG and JC irrespective of their capital account balances, and since no partner is required to restore the deficit balance in his capital account to the partnership upon liquidation (in accordance with paragraph (b)(2)(ii)(b)(3) of this section), the allocations of income, gain, loss, and deduction provided in the partnership agreement do not have economic effect and must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts all partnership income, gain, loss, and deduction (and item thereof) will be reallocated equally between JC and DG. Furthermore, the allocation of the
$100,000 adjusted tax basis of the lease of DG is not, under paragraph (b)(4)(v) of this section, deemed to be in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), and such basis must be reallocated in accordance with the partners' interests in partnership capital or income as determined under section 613A(c)(7)(D). The results in this example would be the same if JC's initial cash contribution were $1,000,000 (instead of $100,000), but in such case the partners should consider whether, and to what extent, the provisions of paragraph (b)(1) of section 1.721-1, and principles related thereto, may be applicable.

(iv) Assume the same facts as in (i) and that for the partnership's first taxable year the simulated depletion deduction with respect to the lease is $10,000. Since DG properly was allocated the entire depletable basis of the lease (such allocation having been recognized as being in accordance with DG's interest in partnership capital with respect to such lease), under paragraph (b)(2)(iv)(k)(1) of this section the partnership's $10,000 simulated depletion deduction is allocated to DG and will reduce his capital account accordingly. If (prior to any additional simulated depletion deductions) the lease is sold for $100,000, paragraph (b)(4)(v) of this section requires that the first $90,000 (i.e., the partnership's simulated adjusted basis in the lease) out of the $100,000 amount realized on such sale be allocated to DG (but does not directly affect his capital account). The partnership agreement allocates the remaining $10,000 amount realized equally between JC and DG (but such allocation does not directly affect their capital accounts). This allocation of the $10,000 portion of amount realized that exceeds the partnership's simulated adjusted basis in the lease will be treated as being in accordance with the partners' allocable shares of such amount realized under section 613A(c)(7)(D) because such allocation will not result in capital account adjustments (under paragraph (b)(2)(iv)(k) of this section) the economic effect of which is insubstantial, and all other partnership allocations are recognized under this paragraph. Under paragraph (b)(2)(iv)(k) of this section, the partners' capital accounts are adjusted upward by the partnership's simulated gain of $10,000 ($100,000 sales price less $90,000 simulated adjusted basis) in proportion to such partners' allocable shares of the $10,000 portion of the total amount realized that exceeds the partnership's $90,000 simulated adjusted basis ($5,000 to JC and $5,000 to DG). If the lease is sold for $50,000, under paragraph (b)(4)(v) of this section the entire $50,000 amount realized on the sale of the lease will be allocated to DG (but will not directly affect his capital account). Under paragraph (b)(2)(iv)(k) of this section the partners' capital accounts will be adjusted downward by the partnership's $40,000 simulated loss ($50,000 sales price less $90,000 simulated adjusted basis) in proportion to the partners' allocable shares of the total amount realized from the property that represents recovery of the partnership's simulated adjusted basis therein. Accordingly, DG's capital account will be reduced by such $40,000.

<table>
<thead>
<tr>
<th>RM</th>
<th>HB</th>
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</thead>
<tbody>
<tr>
<td>Capital account at end of year 2</td>
<td>$27,000</td>
</tr>
<tr>
<td>Less: net loss in year 3 (without nonrecourse deduction)</td>
<td>(13,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deduction in year 3</td>
<td>(63,000)</td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>($49,500)</td>
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### Capital account at end of year

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<th>OC Tax</th>
<th>OC Book</th>
<th>DR Tax</th>
<th>DR Book</th>
<th>DT Tax</th>
<th>DT Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>$113,334</td>
<td>($68,333)</td>
<td>($113,334)</td>
<td>($68,333)</td>
<td>($68,333)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Plus:
- minimum gain chargeback
  - 94,961
  - 68,333
  - 0
  - 0
  - 68,333
  - 68,333

Plus:
- additional gain
  - 66,976
  - 48,333
  - 161,667
  - 116,666
  - 48,333
  - 48,333

Capital account before liquidation

<table>
<thead>
<tr>
<th></th>
<th>OC</th>
<th>DR</th>
<th>DT</th>
</tr>
</thead>
</table>

(c) Contributed property; cross-reference.

See section 1.704-3 for methods of making allocations that take into account precontribution appreciation or diminution in value of property contributed by a partner to a partnership.

(d) Limitation on allowance of losses.

1. A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

2. In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a) (1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.
(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and section 1.752-1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704(d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example (2). At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and sections 1.752-1 and 1.722-1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example (3). At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): Long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

(e) Family partnerships--

(1) In general--
(i) Introduction.

The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of Subchapter K, Chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(ii) Recognition of donee as partner.

With respect to partnerships in which capital is a material income-producing factor, section 704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such interest is derived by purchase or gift from any other person. If a capital interest in a partnership in which capital is a material income-producing factor is created by gift, section 704(e)(2) provides that the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such distributive share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation in such cases, see subparagraph (3) of this paragraph.

(iii) Requirement of complete transfer to donee.

A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

(iv) Capital as a material income-producing factor.

For purposes of section 704(e)(1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other
compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) Capital interest in a partnership.

For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(2) Basic tests as to ownership--

(i) In general.

Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts are not determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership by the donee for the purposes of section 704(e). The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subdivisions (ii) to (x), inclusive, of this subparagraph.

(ii) Retained controls.

The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(a) Retention of control of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business). If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

(b) Limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment.
(c) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership).

(d) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment. The donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(iii) Indirect controls.

Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly, for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(iv) Participation in management.

Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(v) Income distributions.

The actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest, provided the donor has not retained controls inconsistent with real ownership by the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such manner that the donor controls or can control the use or enjoyment of such funds.

(vi) Conduct of partnership business.

In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the
donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance in this connection include:

(a) Compliance with local partnership, fictitious names, and business registration statutes.

(b) Control of business bank accounts.

(c) Recognition of the donee's rights in distributions of partnership property and profits.

(d) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(e) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(f) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(vii) Trustees as partners.

A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

(a) Whether the trust is recognized as a partner in business dealings with customers and creditors, and
(b) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

(viii) Interests (not held in trust) of minor children.

Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. "Judicial supervision of the conduct of the fiduciary" includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(ix) Donees as limited partners.

The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

(x) Motive.

If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be
considered in determining the reality of the ownership of a capital interest acquired by gift.

(3) Allocation of family partnership income--

(i) In general.

(a) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(b) To the extent that the partnership agreement does not allocate the partnership income in accordance with (a) of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(d) The distributive share of partnership income, as determined under (b) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(ii) Special rules.
(a) The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift, indirectly or directly. Where the partnership interest is created indirectly, the term "donor" may include persons other than the nominal transferor. This rule may be illustrated by the following examples:

**Example (1).** A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

**Example (2).** A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

**Example (3).** A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, for purposes of section 704, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(b) The allocation rules set forth in section 704(e) and subdivision (i) of this subparagraph apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(c) In the case of a limited partnership, for the purpose of the allocation provisions of subdivision (i) of this subparagraph, consideration shall be given to the fact that a general partner, unlike a limited partner, risks his credit in the partnership business.

(4) Purchased interest--

(i) In general.

If a purported purchase of a capital interest in a partnership does not meet the requirements of subdivision (ii) of this subparagraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gifts. In a case not qualifying under subdivision (ii) of this subparagraph, if payment of any part of the purchase price is made out of partnership earnings, the transaction may be regarded in the same light as a purported
gift subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase.

(ii) Tests as to reality of purchased interests.

A purchase of a capital interest in a partnership, either directly or by means of a loan or credit extended by a member of the family, will be recognized as bona fide if:

(a) It can be shown that the purchase has the usual characteristics of an arm's-length transaction, considering all relevant factors, including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser (apart from relationship to the seller) and the capacity of the purchaser to incur a legally binding obligation; or

(b) It can be shown, in the absence of characteristics of an arm's-length transaction, that the purchase was genuinely intended to promote the success of the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged, the factors indicated in (a) and (b) of this subdivision shall be taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed.


Sec. 1.704-2 Allocations attributable to nonrecourse liabilities.

(a) TABLE OF CONTENTS.

This paragraph contains a listing of the major headings of this section 1.704-2.

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(b) GENERAL PRINCIPLES AND DEFINITIONS

(1) DEFINITION OF AND ALLOCATIONS OF NONRECOURSE DEDUCTIONS.

Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities ("nonrecourse deductions") cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners' interests in the partnership. If that test is not satisfied, the partners' distributive shares of nonrecourse deductions are determined under section 1.704-1(b)(3), according to the partners' overall economic interests in the partnership. See also paragraph (i) of this section for special rules regarding the allocation of deductions attributable to nonrecourse liabilities for which a partner bears the economic risk of loss (as described in paragraph (b)(4) of this section).

(2) DEFINITION OF AND ALLOCATIONS PURSUANT TO A MINIMUM GAIN CHARGEBACK.

To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess ("partnership minimum gain"). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. Allocations of gain attributable to a decrease in partnership minimum gain (a "minimum gain chargeback," as required under paragraph (f) of this section) cannot have economic effect because the gain merely offsets nonrecourse deductions previously claimed by the partnership. Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds.
attributable to a nonrecourse borrowing. Paragraph (e) of this section provides a
test that, if met, deems allocations of partnership income pursuant to a minimum
gain chargeback to be in accordance with the partners’ interests in the
partnership. If property encumbered by a nonrecourse liability is reflected on the
partnership’s books at a value that differs from its adjusted tax basis, paragraph
(d)(3) of this section provides that minimum gain is determined with reference to
the property’s book basis. See also paragraph (i)(4) of this section for special
rules regarding the minimum gain chargeback requirement for partner
nonrecourse debt.

(3) DEFINITION OF NONRECOURSE LIABILITY.

"Nonrecourse liability" means a nonrecourse liability as defined in section
1.752-1(a)(2).

(4) DEFINITION OF PARTNER NONRECOURSE DEBT.

"Partner nonrecourse debt" or "partner nonrecourse liability" means any
partnership liability to the extent the liability is nonrecourse for purposes of
section 1.1001-2, and a partner or related person (within the meaning of section
1.752-4(b)) bears the economic risk of loss under section 1.752-2 because, for
example, the partner or related person is the creditor or a guarantor.

(c) AMOUNT OF NONRECOURSE DEDUCTIONS.

The amount of nonrecourse deductions for a partnership taxable year equals the
net increase in partnership minimum gain during the year (determined under
paragraph (d) of this section), reduced (but not below zero) by the aggregate
distributions made during the year of proceeds of a nonrecourse liability that are
allocable to an increase in partnership minimum gain (determined under paragraph
(h) of this section). See paragraph (m), Examples (1)(i) and (vi), (2), and (3) of this
section. However, increases in partnership minimum gain resulting from
conversions, refinancings, or other changes to a debt instrument (as described in
paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse
deductions consist first of certain depreciation or cost recovery deductions and then,
if necessary, a pro rata portion of other partnership losses, deductions, and section
705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried
over. See paragraphs (j)(1)(ii) and (iii) of this section for more specific ordering rules.
See also paragraph (m), Example (1)(vi) of this section.

(d) PARTNERSHIP MINIMUM GAIN

(1) AMOUNT OF PARTNERSHIP MINIMUM GAIN.

The amount of partnership minimum gain is determined by first computing for
each partnership nonrecourse liability any gain the partnership would realize if it
disposed of the property subject to that liability for no consideration other than
full satisfaction of the liability, and then aggregating the separately computed
gains. The amount of partnership minimum gain includes minimum gain arising
from a conversion, refinancing, or other change to a debt instrument, as
described in paragraph (g)(3) of this section, only to the extent a partner is
allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year. See paragraph (m), Examples (1)(i) and (iv), (2), and (3) of this section.

(2) PROPERTY SUBJECT TO MORE THAN ONE LIABILITY.

(i) In general.

If property is subject to more than one liability, only the portion of the property's adjusted tax basis that is allocated to a nonrecourse liability under paragraph (d)(2)(ii) of this section is used to compute minimum gain with respect to that liability.

(ii) ALLOCATING LIABILITIES.

If property is subject to two or more liabilities of equal priority, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. See paragraph (m), Example (1)(v) and (vii) of this section.

(3) PARTNERSHIP MINIMUM GAIN IF THERE IS A BOOK/TAX DISPARITY.

If partnership property subject to one or more nonrecourse liabilities is, under section 1.704-1(b)(2)(iv)(d), (f), or (r), reflected on the partnership's books at a value that differs from its adjusted tax basis, the determinations under this section are made with reference to the property's book value. See section 704(c) and section 1.704-1(b)(4)(i) for principles that govern the treatment of a partner's share of minimum gain that is eliminated by the revaluation. See also paragraph (m), Example (3) of this section.

(4) SPECIAL RULE FOR ONE YEAR OF REVALUATION.

If the partners' capital accounts are increased pursuant to section 1.704-1(b)(2)(iv)(d), (f), or (r) to reflect a revaluation of partnership property subject to a nonrecourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of the revaluation is determined by:

(i) First calculating the net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount; and

(ii) Then adding back any decrease in minimum gain arising solely from the revaluation.

See paragraph (m), Example (3)(iii) of this section. If the partners' capital accounts are decreased to reflect a revaluation, the net increases or
decreases in partnership minimum gain are determined in the same manner as in the year before the revaluation, but by using book values rather than adjusted tax bases. See section 7701(g) and section 1.704-1(b)(2)(iv)(f)(1) (property being revalued cannot be booked down below the amount of any nonrecourse liability to which the property is subject).

(e) REQUIREMENTS TO BE SATISFIED.

Allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if --

(1) Throughout the full term of the partnership requirements (1) and (2) of section 1.704-1(b)(2)(ii)(b) are satisfied (i.e., capital accounts are maintained in accordance with section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either section 1.704-1(b)(2)(ii)(b) or section 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;

(3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under section 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under section 1.704-1(b)(4)(v)).

(f) MINIMUM GAIN CHARGEBACK REQUIREMENT

(1) In general.

If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)).

(2) EXCEPTION FOR CERTAIN CONVERSIONS AND REFINANCINGS.

A partner is not subject to the minimum gain chargeback requirement to the extent the partner's share of the net decrease in partnership minimum gain is
caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of section 1.752-2) for the newly guaranteed, refinanced, or otherwise changed liability.

(3) EXCEPTION FOR CERTAIN CAPITAL CONTRIBUTIONS.

A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner’s share of the net decrease in partnership minimum gain results from the repayment or the increase to the property’s basis. See paragraph (m), Example (1)(iv) of this section.

(4) WAIVER FOR CERTAIN INCOME ALLOCATIONS THAT FAIL TO MEET MINIMUM GAIN CHARGEBACK REQUIREMENT IF MINIMUM GAIN CHARGEBACK DISTORTS ECONOMIC ARRANGEMENT.

In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The following facts must be demonstrated in order for a request for a waiver to be considered:

(i) The partners have made capital contributions or received net income allocations that have restored the previous nonrecourse deductions and the distributions attributable to proceeds of a nonrecourse liability; and

(ii) The minimum gain chargeback requirement would distort the partners’ economic arrangement as reflected in the partnership agreement and as evidenced over the term of the partnership by the partnership’s allocations and distributions and the partners’ contributions.

(5) ADDITIONAL EXCEPTIONS.

The Commissioner may, by revenue ruling, provide additional exceptions to the minimum gain chargeback requirement.

(6) PARTNERSHIP ITEMS SUBJECT TO THE MINIMUM GAIN CHARGEBACK REQUIREMENT.

Any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then if necessary consists of a pro rata portion of the partnership’s other items of income and gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership’s income and gains for the taxable year, the excess carries over. See paragraphs (j)(2)(i) and (iii) of this section for more specific ordering rules.
EXAMPLES.

The following examples illustrate the provisions in section 1.704-2(f).

EXAMPLE 1. Partnership AB consists of two partners, limited partner A and general partner B. Partner A contributes $90 and Partner B contributes $10 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that, except as otherwise required by section 704 (c), all losses will be allocated 94 percent to A and 10 percent to B; and that all income will be allocated first to restore previous losses and thereafter 50 percent to A and 50 percent to B. Distributions are made first to return initial capital to the partners and then 50 percent to A and 50 percent to B. Final distributions are made in accordance with capital account balances. The partnership borrows $200 on a nonrecourse basis from an unrelated third party and purchases an asset for $300. The partnership's only tax item for each of the first three years is $100 of depreciation on the asset. A's and B's shares of minimum gain (under paragraph (g) of this section) and deficit capital account balances are $180 and $20 respectively at the end of the third year. In the fourth year, the partnership earns $400 of net operating income and allocates the first $300 to restore the previous losses (i.e., $270 to A and $30 to B); the last $100 is allocated $50 each. The partnership distributes $200 of the available cash that same year; the first $100 is distributed $90 to A and $10 to B to return their capital contributions; the last $100 is distribute; $50 each to reflect their ratio for sharing profits.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$90</td>
<td>$10</td>
</tr>
<tr>
<td>Less: net loss in years 1-3</td>
<td>($270)</td>
<td>($30)</td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>($180)</td>
<td>($20)</td>
</tr>
<tr>
<td>Allocation of operating income to restore nonrecourse deductions</td>
<td>$180</td>
<td>$20</td>
</tr>
<tr>
<td>Allocation of operating income to restore capital contributions</td>
<td>$90</td>
<td>$10</td>
</tr>
<tr>
<td>Allocation of operating income to reflect profits</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Capital accounts after allocation of operating income</td>
<td>$140</td>
<td>$60</td>
</tr>
<tr>
<td>Distribution reflecting capital contribution</td>
<td>($90)</td>
<td>($10)</td>
</tr>
<tr>
<td>Distribution in profit-sharing ratio</td>
<td>($50)</td>
<td>($50)</td>
</tr>
<tr>
<td>Capital accounts following distribution</td>
<td>($0)</td>
<td>($0)</td>
</tr>
</tbody>
</table>

In the fifth year, the partnership sells the property for $300 and realizes $300 of gain. $200 of the proceeds are used to pay the nonrecourse lender. The partnership $300 to distribute, and the partners expect to share that equally. Absent a waiver under paragraph (f)(4) of this section, the minimum gain chargeback would require the partnership to allocate the first $200 of the gain $180 to A and $20 to B, which would distort their economic arrangement. This allocation, together with the allocation of the $100 profit $50 to each partner, would result in A having a positive capital account balance of $230 and B having a positive capital account balance of $70. The allocation of income in year 4 in effect anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership would not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise his or her discretion to waive the minimum gain chargeback requirement and recognize allocations that would allow A and B to share equally the gain on the sale of the property. These allocations would bring
the partners' capital accounts to $150 each, allowing them to share the last $300 equally. The Commissioner may, in his or her discretion, permit this allocation pursuant to paragraph (f)(4) of this section because the minimum gain chargeback would distort the partners' economic arrangement over the term of the partnership as reflected in the partnership agreement and as evidenced by the partners' contributions and the partnership's allocations and distributions.

EXAMPLE 2. A and B form a partnership, contribute $25 each to the partnership's capital, and agree to share all losses and profits 50 percent each. Neither partner has an unconditional deficit restoration obligation and all the requirements in paragraph (e) of this section are met. The partnership obtains a nonrecourse loan from an unrelated third party of $100 and purchases two assets, stock for $50 and depreciable property for $100. The nonrecourse loan is secured by the partnership's depreciable property. The partnership generates $20 of depreciation in each of the first five years as its only tax item. These deductions are properly treated as nonrecourse deductions and the allocation of these deductions 50 percent to A and 50 percent to B is deemed to be in accordance with the partners' interests in the partnership. At the end of year five, A and B each have a $25 deficit capital account and a $50 share of partnership minimum gain. In the beginning of year six, (at the lender's request), A guarantees the entire nonrecourse liability. Pursuant to paragraph (d)(1) of this section, the partnership has a net decrease in minimum gain of $100 and under paragraph (g)(2) of this section, A's and B's shares of that net decrease are $50 each. Under paragraph (f)(1) of this section (the minimum gain chargeback requirement), B is subject to a $50 minimum gain chargeback. Because the partnership has no gross income in year six, the entire $50 carries over as a minimum gain chargeback requirement to succeeding taxable years until there is enough income to cover the minimum gain chargeback requirement. Under the exception to the minimum gain chargeback in paragraph (f)(2) of this section, A is not subject to a minimum gain chargeback for A's $50 share of the net decrease because A bears the economic risk of loss for the liability. Instead, A's share of partner nonrecourse debt minimum gain is $50 pursuant to paragraph (i)(3) of this section. In year seven, the partnership earns $100 of net operating income and uses the money to repay the entire $100 nonrecourse debt (that A has guaranteed). Under paragraph (i)(3) of this section, the partnership has a net decrease in partner nonrecourse debt minimum gain of $50. B must be allocated $50 of the operating income pursuant to the carried over minimum gain chargeback requirement; pursuant to paragraph (i)(4) of this section, the other $50 of operating income must be allocated to A as a partner nonrecourse debt minimum gain chargeback.

(g) SHARES OF PARTNERSHIP MINIMUM GAIN

(1) PARTNER'S SHARE OF PARTNERSHIP MINIMUM GAIN.

Except as increased in paragraph (g)(3) of this section, a partner's share of partnership minimum gain at the end of any partnership taxable year equals:

(i) the sum of nonrecourse deductions allocated to that partner (and to that partner's predecessors' in interest) up to that time and the distributions made to that partner (and to that partner's predecessors' in interest) up to
that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain (see paragraph (h)(1) of this section); minus

(ii) the sum of that partner's (and that partner's predecessors' in interest) aggregate share of the net decreases in partnership minimum gain plus their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities.

For purposes of section 1.704-1(b)(2)(ii)(d), a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore. See paragraph (m), Examples (1)(i) and (3)(i) of this section.

(2) PARTNER'S SHARE OF THE NET DECREASE IN PARTNERSHIP MINIMUM GAIN.

A partner's share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner's percentage share of the partnership's minimum gain at the end of the immediately preceding taxable year. A partner's share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the increase in the partner's capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation. See paragraph (m), Example (3)(ii) of this section.

(3) CONVERSIONS OF RECOURSE OR PARTNER NONRECOUSE DEBT INTO NONRECOUSE DEBT.

A partner's share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a refinancing, the lapse of a guarantee, or other change to a debt instrument causes a recourse or partner nonrecourse liability to become partially or wholly nonrecourse. If a recourse liability becomes a nonrecourse liability, a partner has a share of the partnership's minimum gain that results from the conversion equal to the partner's deficit capital account (determined under section 1.704-1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of the preceding sentence, the determination of the extent to which a partner bears the economic burden for a deficit capital account is made by determining the consequences to the partner in the case of a complete liquidation of the partnership immediately after the conversion applying the rules described in section 1.704-1(b)(2)(iii)(c) that deem the value of partnership property to equal its basis, taking into account section 7701(g) in the case of property that secures nonrecourse indebtedness. If a partner nonrecourse debt becomes a nonrecourse liability, the partner's share of partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under paragraph (i)(4) of this section.

(h) DISTRIBUTION OF NONRECOUSE LIABILITY PROCEEDS ALLOCABLE TO AN INCREASE IN PARTNERSHIP MINIMUM GAIN
(1) IN GENERAL.

If during its taxable year a partnership makes a distribution to the partners allocable to the proceeds of a nonrecourse liability, the distribution is allocable to an increase in partnership minimum gain among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain to the extent the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property's adjusted tax basis. See paragraph (m), Example (1)(vi) of this section. If the net increase in partnership minimum gain for a partnership taxable year is allocable to more than one nonrecourse liability, the net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain.

(2) DISTRIBUTION ALLOCABLE TO NONRECOURSE LIABILITY PROCEEDS.

A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. The rules prescribed under section 1.163-8T for allocating debt proceeds among expenditures (applying those rules to the partnership as if it were an individual) constitute a reasonable method for determining whether the nonrecourse liability proceeds are distributed to the partners and the partners to whom the proceeds are distributed.

(3) OPTION WHEN THERE IS AN OBLIGATION TO RESTORE.

A partnership may treat any distribution to a partner of the proceeds of a nonrecourse liability (that would otherwise be allocable to an increase in partnership minimum gain) as a distribution that is not allocable to an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the partner's capital account that exceeds the amount the partner is otherwise obligated to restore (within the meaning of section 1.704-1(b)(2)(ii)(c)) as of the end of the partnership taxable year in which the distribution occurs.

(4) CARRYOVER TO IMMEDIATELY SUCCEEDING TAXABLE YEAR.

The carryover rule of this paragraph applies if the net increase in partnership minimum gain for a partnership taxable year that is allocable to a nonrecourse liability under paragraph (h)(2) of this section exceeds the distributions allocable to the proceeds of the liability ("excess allocable amount"), and all or part of the net increase in partnership minimum gain for the year is carried over as an increase in partnership minimum gain for the immediately succeeding taxable year (pursuant to paragraph (j)(1)(iii) of this section). If the carryover rule of this paragraph applies, the excess allocable amount (or the amount carried over under paragraph (j)(1)(iii) of this section, if less) is treated in the succeeding taxable year as an increase in partnership minimum gain that arose in that year as a result of incurring the nonrecourse liability to which the excess allocable amount is attributable. See paragraph (m), Example (1)(vi) of this section. If for a partnership taxable year there is an excess allocable amount with respect to more than one partnership nonrecourse liability, the excess allocable amount is
allocated to each liability in proportion to the amount each liability contributed to the increase in minimum gain.

(i) PARTNERSHIP NONRECOGNITION LIABILITIES WHERE A PARTNER BEARS THE ECONOMIC RISK OF LOSS

(1) IN GENERAL.

Partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability ("partner nonrecourse deductions," as defined in paragraph (i)(2) of this section) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability.

(2) DEFINITION OF AND DETERMINATION OF PARTNER NONRECOGNITION DEDUCTIONS.

For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the net increase during the year in minimum gain attributable to the partner nonrecourse debt ("partner nonrecourse debt minimum gain"), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. See paragraph (m), Example (1)(viii) and (ix) of this section. The determination of which partnership items constitute the partner nonrecourse deductions with respect to a partner nonrecourse debt must be made in a manner consistent with the provisions of paragraphs (c) and (j)(1)(i) and (iii) of this section.

(3) DETERMINATION OF PARTNER NONRECOGNITION DEBT MINIMUM GAIN.

For any partnership taxable year, the determination of partner nonrecourse debt minimum gain and the net increase or decrease in partner nonrecourse debt minimum gain must be made in a manner consistent with the provisions of paragraphs (d) and (g)(3) of this section.

(4) CHARGEBACK OF PARTNER NONRECOGNITION DEBT MINIMUM GAIN.

If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain (determined under paragraph (i)(5) of this section) as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner's share of the net decrease in the partner nonrecourse debt minimum gain. A partner's share of the net decrease in partner nonrecourse debt minimum gain is determined in a manner consistent with the provisions of paragraph (g)(2) of this section.
section. A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner nonrecourse debt minimum gain arises because the liability ceases to be partner nonrecourse debt due to a conversion, refinancing, or other change in the debt instrument that causes it to become partially or wholly a nonrecourse liability. The amount that would otherwise be subject to the partner nonrecourse debt minimum gain chargeback is added to the partner's share of partnership minimum gain under paragraph (g)(3) of this section. In addition, rules consistent with the provisions of paragraphs (f)(2), (3), (4), and (5) of this section apply with respect to partner nonrecourse debt in appropriate circumstances. The determination of which items of partnership income and gain must be allocated pursuant to this paragraph (i)(4) is made in a manner that is consistent with the provisions of paragraph (f)(6) of this section. See paragraph (j)(2)(ii) and (iii) of this section for more specific rules.

(5) PARTNER'S SHARE OF PARTNER NONRECOURSE DEBT MINIMUM GAIN.

A partner's share of partner nonrecourse debt minimum gain at the end of any partnership taxable year is determined in a manner consistent with the provisions of paragraphs (g)(1) and (g)(3) of this section with respect to each particular partner nonrecourse debt for which the partner bears the economic risk of loss. For purposes of section 1.704-1(b)(2)(ii)(d), a partner's share of partner nonrecourse debt minimum gain is added to the limited dollar amount if any, of the deficit balance in the partner's capital account that the partner is obligated to restore, and the partner is not otherwise considered to have a deficit restoration obligation as a result of bearing the economic risk of loss for any partner nonrecourse debt. See paragraph (m), EXAMPLE (1)(viii) of this section.

(6) DISTRIBUTION OF PARTNER NONRECOURSE DEBT PROCEEDS ALLOCABLE TO AN INCREASE IN PARTNER NONRECOURSE DEBT MINIMUM GAIN.

Rules consistent with the provisions of paragraph (h) of this section apply to distributions of the proceeds of partner nonrecourse debt.

(j) ORDERING RULES.

For purposes of this section, the following ordering rules apply to partnership items. Notwithstanding any other provision in this section and section 1.704-1 allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations.

(1) Treatment of partnership losses and deductions.

(i) Partner nonrecourse deductions. Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in the amount determined under paragraph (i)(2) of this section (determining partner nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;
(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction and any excess is treated as a partner nonrecourse deduction under this paragraph (j)(1)(i).

(ii) PARTNERSHIP NONRECOURSE DEDUCTIONS.

Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under paragraph (c) of this section (determining nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt is first treated as a partner nonrecourse deduction and any excess is treated as a partnership nonrecourse deduction under this paragraph (j)(1)(ii). Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction.

(iii) CARRYOVER TO SUCCEEDING TAXABLE YEAR.

If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and section 705(a)(2)(B) expenditures for the taxable year (determined under paragraphs (j)(1)(i) and (ii) of this section), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year. See paragraph (m), EXAMPLE (1)(vi) of this section.

(2) TREATMENT OF PARTNERSHIP INCOME AND GAINS.

(i) MINIMUM GAIN CHARGEBACK.

Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under paragraph (f) of this section) are allocated as a minimum gain chargeback in the following order:

(A) First, gain from the disposition of property subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year. Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a
minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under paragraph (j)(2)(ii) of this section.

(ii) CHARGEBACK ATTRIBUTABLE TO DECREASE IN PARTNER NONRECOURSE DEBT MINIMUM GAIN.

Items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback (determined under paragraph (i)(4) of this section) are allocated to satisfy a partner nonrecourse debt minimum gain chargeback in the following order:

(A) First, gain from the disposition of property subject to partner nonrecourse debt;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year. Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent not allocated under paragraph (j)(2)(i) of this section. An item of partnership income and gain that is allocated to satisfy a minimum gain chargeback under paragraph (f) of this section is not allocated to satisfy a minimum gain chargeback under paragraph (i)(4).

(iii) CARRYOVER TO SUCCEEDING TAXABLE YEAR.

If a minimum gain chargeback requirement (determined under paragraphs (f) and (i)(4) of this section) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.

(k) TIERED PARTNERSHIPS.

For purposes of this section, the following rules determine the effect on partnership minimum gain when a partnership ("upper-tier partnership") is a partner in another partnership ("lower-tier partnership").

(1) INCREASE IN UPPER-TIER PARTNERSHIP'S MINIMUM GAIN.

The sum of the nonrecourse deductions that the lower-tier partnership allocates to the upper-tier partnership for any taxable year of the upper-tier partnership, and the distributions made during that taxable year from the lower-tier partnership to the upper-tier partnership of proceeds of nonrecourse debt that are allocable to an increase in the lower-tier partnership's minimum gain, is treated as an increase in the upper-tier partnership's minimum gain.

(2) DECREASE IN UPPER-TIER PARTNERSHIP'S MINIMUM GAIN.

The upper-tier partnership's share for its taxable year of the lower-tier partnership's net decrease in its minimum gain is treated as a decrease in the upper-tier partnership's minimum gain for that taxable year.
(3) NONRECOUROSE DEBT PROCEEDS DISTRIBUTED FROM THE LOWER-TIER PARTNERSHIP TO THE UPPER-TIER PARTNERSHIP.

All distributions from the lower-tier partnership to the upper-tier partnership during the upper-tier partnership's taxable year of proceeds of a nonrecourse liability allocable to an increase in the lower-tier partnership's minimum gain are treated as proceeds of a nonrecourse liability of the upper-tier partnership. The increase in the upper-tier partnership's minimum gain (under paragraph (k)(1) of this section) attributable to the receipt of those distributions is, for purposes of paragraph (h) of this section, treated as an increase in the upper-tier partnership's minimum gain arising from encumbering property of the upper-tier partnership with a nonrecourse liability of the upper-tier partnership.

(4) NONRECOUROSE DEDUCTIONS OF LOWER-TIER PARTNERSHIP TREATED AS DEPRECIATION BY UPPER-TIER PARTNERSHIP.

For purposes of paragraph (c) of this section, all nonrecourse deductions allocated by the lower-tier partnership to the upper-tier partnership for the upper-tier partnership's taxable year are treated as depreciation or cost recovery deductions with respect to property owned by the upper-tier partnership and subject to a nonrecourse liability of the upper-tier partnership with respect to which minimum gain increased during the year by the amount of the nonrecourse deductions.

(5) COORDINATION WITH PARTNER NONRECOUROSE DEBT RULES.

The lower-tier partnership's liabilities that are treated as the upper-tier partnership's liabilities under section 1.752-4(a) are treated as the upper-tier partnership's liabilities for purposes of applying paragraph (i) of this section. Rules consistent with the provisions of paragraphs (k)(1) through (k)(4) of this section apply to determine the allocations that the upper-tier partnership must make with respect to any liability that constitutes a nonrecourse debt for which one or more partners of the upper-tier partnership bear the economic risk of loss.

(l) EFFECTIVE DATES

(1) IN GENERAL.

(i) PROSPECTIVE APPLICATION.

Except as otherwise provided in this paragraph (l), this section applies for partnership taxable years beginning on or after December 28, 1991. For the rules applicable to taxable years beginning after December 29, 1988, and before December 28, 1991, see former section 1.704-1T(b)(4)(iv). For the rules applicable to taxable years beginning on or before December 29, 1988, see former section 1.704-1(b)(4)(iv).

(ii) PARTNERSHIPS SUBJECT TO TEMPORARY REGULATIONS.

If a partnership agreement entered into after December 29, 1988, and before December 28, 1991, or a partnership agreement entered into on or
before December 29, 1988, that elected to apply former section 1.704-1T(b)(4)(iv) (as contained in the CFR edition revised as of April 1, 1991), complied with the provisions of former section 1.704-1T(b)(4)(iv) before December 28, 1991, --

(A) The provisions of former section 1.704-1T(b)(4)(iv) continue to apply to the partnership for any taxable year beginning on or after December 28, 1991, (unless the partnership makes an election under paragraph (l)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(iii) PARTNERSHIPS SUBJECT TO FORMER REGULATIONS.

If a partnership agreement entered into on or before December 29, 1988, complied with the provisions of former section 1.704-1(b)(4)(iv)(d) on or before that date --

(A) The provisions of former section 1.704-1(b)(4)(iv)(a) through (f) continue to apply to the partnership for any taxable year beginning after that date (unless the partnership made an election under section 1.704-1T(b)(4)(iv)(m)(4) in a partnership taxable year ending before December 28, 1991, or makes an election under paragraph (l)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(2) SPECIAL RULE APPLICABLE TO PRE-JANUARY 30, 1989, RELATED PARTY NONRECKONS DEBT.

For purposes of this section and former section 1.704-1T(b)(4)(iv), if --

(i) A partnership liability would, but for this paragraph (l)(2) of this section, constitute a partner nonrecourse debt; and

(ii) Sections 1.752-1 through -3 or former sections 1.752-1T through -3T (whichever is applicable) do not apply to the liability; the liability is, notwithstanding paragraphs (i) and (b)(4) of this section, treated as a nonrecourse liability of the partnership, and not as a partner nonrecourse debt, to the extent the liability would be so treated under this section (or section 1.704-1T(b)(4)(iv)) if the determination of the extent to which one or more partners bears the economic risk of loss for the liability under section 1.752-1 or former section 1.752-1T were made without regard to the economic risk of loss that any partner would otherwise be considered to bear for the liability by reason of any obligation undertaken or interest as a creditor acquired prior to January 30, 1989, by a person related to the partner (within the meaning of section 1.752-4(b) or former section 1.752-1T(h)). For purposes of the preceding sentence, if a related person undertakes an
obligation or acquires an interest as a creditor on or after January 30, 1989, pursuant to a written binding contract in effect prior to January 30, 1989, and at all times thereafter, the obligation or interest as a creditor is treated as if it were undertaken or acquired prior to January 30, 1989. However, for partnership taxable years beginning on or after December 29, 1988, a pre-January 30, 1989, liability, other than a liability subject to paragraph (l)(3) of this section or former section 1.704-1T(b)(4)(iv)(m)(3) (whichever is applicable), that is treated as grandfathered under former sections 1.752-1T through -3T (whichever is applicable) will be treated as a nonrecourse liability for purposes of this section provided that all partners in the partnership consistently treat the liability as nonrecourse for partnership taxable years beginning on or after December 29, 1988.

(3) TRANSITION RULE FOR PRE-MARCH 1, 1984, PARTNER NONRECOERCSE DEBT.

If a partnership liability would, but for this paragraph (l)(3) or former section 1.704-1T(b)(4)(iv), constitute a partner nonrecourse debt and the liability constitutes grandfathered partner nonrecourse debt that is appropriately treated as a nonrecourse liability of the partnership under section 1.752-1 (as in effect prior to December 29, 1988) --

(i) The liability is, notwithstanding paragraphs (i) and (b)(4) of this section, former section 1.704-1T(b)(4)(iv), and former section 1.704-1(b)(4)(iv), treated as a nonrecourse liability of the partnership for purposes of this section and for purposes of former section 1.704-1T(b)(4)(iv) and former section 1.704-1(b)(4)(iv) to the extent of the amount, if any by which the smallest outstanding balance of the liability during the period beginning at the end of the first partnership taxable year ending on or after December 31, 1986, and ending at the time of any determination under this paragraph (l)(3)(i) or former section 1.704-1T(b)(4)(iv)(m)(3)(i) exceeds the aggregate amount of the adjusted basis (or book value) of partnership property allocable to the liability (determined in accordance with former section 1.704-1(b)(4)(iv)(c)(1) and (2) at the end of the first partnership taxable year ending on or after December 31, 1986); and

(ii) In applying this section to the liability, former section 1.704-1(b)(c)(iv)(c)(1) and (2) is applied as if all of the adjusted basis of partnership property allocable to the liability is allocable to the portion of the liability that is treated as a partner nonrecourse debt and as if none of the adjusted basis of partnership property that is allocable to the liability is allocable to the portion of the liability that is treated as a nonrecourse liability under this paragraph (l)(3) and former section 1.704-1T(b)(4)(iv)(m)(3)(i).

For purposes of the preceding sentence, a grandfathered partner debt is any partnership liability that was not subject to former sections 1.752-1T and -3T but that would have been subject to those sections under section 1.752-4T(b) if the liability had arisen (other than pursuant to a written binding contract) on or after March 1, 1984. A partnership liability is not considered to have been subject to sections 1.752-2T and -3T solely because a portion of
the liability was treated as a liability to which those sections apply under section 1.752-4T(e).

(4) ELECTION.

A partnership may elect to apply the provisions of this section to the first taxable year of the partnership ending on or after December 28, 1991. An election under this paragraph (l)(4) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and just declare that an election is made under this paragraph (l)(4).

(m) EXAMPLES.

The principles of this section are illustrated by the following examples:

EXAMPLE 1. NONRECOERCSE DEDUCTIONS AND PARTNERSHIP MINIMUM GAIN. For EXAMPLE 1, unless otherwise provided, the following facts are assumed. LP, the limited partner, and GP, the general partner, form a limited partnership to acquire and operate a commercial office building. LP contributes $180,000, and GP contributes $20,000. The partnership obtains an $800,000 nonrecourse loan and purchases the building (on leased land) for $1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that GP will be required to restore any deficit balance in GP's capital account following the liquidation of GP's interest (as set forth in section 1.704-1(b)(2)(ii)(b)(3)), and LP will not be required to restore any deficit balance in LP's capital account following the liquidation of LP's interest. The partnership agreement contains the following provisions required by paragraph (e) of this section: a qualified income offset (as defined in section 1.704-1(b)(2)(ii)(d)); a minimum gain chargeback (in accordance with paragraph (f) of this section); a provision that the partners' capital accounts will be determined and maintained in accordance with section 1.704-1(b)(2)(ii)(b)(1); and a provision that distributions will be made in accordance with partners' positive capital account balances (as set forth in section 1.704-1(b)(2)(ii)(b)(2)). In addition, as of the end of each partnership taxable year discussed herein, the items described in section 1.704-1(b)(2)(ii)(d)(4), (5), and (6) are not reasonably expected to cause or increase a deficit balance in LP's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made 90 percent to LP and 10 percent to GP until a total of $200,000 has been distributed, and thereafter all the distributions will be made equally to LP and GP. In each of the partnership's first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a net taxable loss of
$85,000 in each of those years. The allocations of these losses 90 percent to LP and 10 percent to GP have substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$180,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: net loss in years 1 and 2</td>
<td>(153,000)</td>
<td>(17,000)</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>$27,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

In the partnership's third taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000. The partnership makes no distributions.

(i) CALCULATION OF NONRECURSORSE DEDUCTIONS AND PARTNERSHIP MINIMUM GAIN.

If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of the third year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of the third year (and the net increase in partnership minimum gain during the year) is $70,000, there are partnership nonrecourse deductions for that year of $70,000, consisting of depreciation deductions allowable with respect to the building of $70,000. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $85,000, including the $70,000 nonrecourse deduction, are allocated 90 percent to LP and 10 percent to GP. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at end of year 2</td>
<td>$27,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Less: net loss in year 3 (without nonrecourse deduction)</td>
<td>(13,500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 3</td>
<td>(63,000)</td>
<td>(7,000)</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>($49,500)</td>
<td>($5,500)</td>
</tr>
</tbody>
</table>

The allocation of the $70,000 nonrecourse deduction satisfies requirement (2) of paragraph (e) of this section because it is consistent with allocations having substantial economic effect of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, LP's and GP's shares of partnership minimum gain are $63,000 and $7,000, respectively. Therefore, pursuant to paragraph (g)(1) of this section, LP is treated as obligated to restore a deficit capital account balance of $63,000, so that in the succeeding year LP could be allocated up to an additional $13,500 of partnership deductions, losses, and section 705(a)(2)(B) items that are not nonrecourse deductions. Even though this allocation would increase a deficit capital account balance, it would be considered to have economic effect under the alternate economic effect test contained in section 1.704-1(b)(2)(ii)(d). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership's fourth taxable year (and had no other economic
activity in that year), the partnership minimum gain would be decreased from $70,000 to zero, and the minimum gain chargeback would require that LP and GP be allocated $63,000 and $7,000, respectively, of the gain from that disposition.

(ii) ILLUSTRATION OF REASONABLE CONSISTENCY REQUIREMENT.

Assume instead that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between LP and GP. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The equal allocation of excess income and gain has substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$180,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: net loss in years 1 and 2</td>
<td>(153,000)</td>
<td>(17,000)</td>
</tr>
<tr>
<td>Less: net loss in year 3 (without nonrecourse deductions)</td>
<td>(13,500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 3</td>
<td>(35,000)</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>($21,500)</td>
<td>($33,500)</td>
</tr>
</tbody>
</table>

The allocation of the $70,000 nonrecourse deduction equally between LP and GP satisfies requirement (2) of paragraph (e) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. The allocation of the nonrecourse deductions 75 percent to LP and 25 percent to GP (or in any other ratio between 90 percent to LP/10 percent to GP and 50 percent to LP/50 percent to GP) also would satisfy requirement (2) of paragraph (e) of this section.

(iii) ALLOCATION OF NONRECOURSE DEDUCTIONS THAT FAILS REASONABLE CONSISTENCY REQUIREMENT.

Assume instead that the partnership agreement provides that LP will be allocated 99 percent, and GP 1 percent, of all nonrecourse deductions of the partnership. Allocating nonrecourse deductions this way does not satisfy requirement (2) of paragraph (e) of this section because the allocations are not reasonably consistent with allocations, having substantial economic effect, of any other significant partnership item attributable to the building. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners' overall economic interests in the partnership, determined under section 1.704-1(b)(3)(ii).

(iv) CAPITAL CONTRIBUTION TO PAY DOWN NONRECOURSE DEBT.

At the beginning of the partnership's fourth taxable year, LP contributes $144,000 and GP contributes $16,000 of additional capital to the partnership, which the partnership immediately uses to reduce the amount of its nonrecourse liability from $800,000 to $640,000. In addition, in the partnership's fourth taxable year, it
generates rental income of $95,000, operating expenses of $10,000, interest expense of $64,000 (consistent with the debt reduction), and a depreciation deduction of $90,000, resulting in a net taxable loss of $69,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($640,000 amount realized less $640,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of the year is zero, which represents a net decrease in partnership minimum gain of $70,000 during the year. LP’s and GP’s shares of this net decrease are $63,000 and $7,000 respectively, so that at the end of the partnership's fourth taxable year, LP’s and GP’s shares of partnership minimum gain are zero. Although there has been a net decrease in partnership minimum gain, pursuant to paragraph (f)(3) of this section LP and GP are not subject to a minimum gain chargeback.

---

(v) LOANS OF UNEQUAL PRIORITY.

Assume instead that the building acquired by the partnership is secured by a $700,000 nonrecourse loan and a $100,000 recourse loan, subordinate in priority to the nonrecourse loan. Under paragraph (d)(2) of this section, $700,000 of the adjusted basis of the building at the end of the partnership’s third taxable year is allocated to the nonrecourse liability (with the remaining $30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($700,000 amount realized less $700,000 adjusted tax basis). Therefore, there is no minimum gain (or increase in minimum gain) at the end of that partnership’s third taxable year. If, however, the $700,000 nonrecourse loan were subordinate in priority to the $100,000 recourse loan, under paragraph (d)(2) of this section, the first $100,000 of adjusted tax basis in the building would be allocated to the recourse liability, leaving only $630,000 of the adjusted basis of the building to be allocated to the $700,000 nonrecourse loan. In that case, the balance of the $700,000 nonrecourse liability would exceed the adjusted tax basis of the building by $70,000, so that there would be $70,000 of minimum gain (and a $70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) NONRECOURSE BORROWING; DISTRIBUTION OF PROCEEDS IN SUBSEQUENT YEAR.

The partnership obtains an additional nonrecourse loan of $200,000 at the end of its fourth taxable year, secured by a second mortgage on the building, and distributes $180,000 of this cash to its partners at the beginning of its fifth taxable year. In addition, in its fourth and fifth taxable years, the partnership again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000 ($100,000 in the fifth taxable year reflecting the interest paid on both
liabilities), and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000 ($105,000 in the fifth taxable year reflecting the interest paid on both liabilities). The partnership has distributed its $5,000 of operating cash flow in each year ($95,000 of rental income less $10,000 of operating expense and $80,000 of interest expense) to LP and GP at the end of each year. If the partnership were to dispose of the building in full satisfaction of both nonrecourse liabilities at the end of its fourth taxable year, the partnership would realize $360,000 of gain ($1,000,000 amount realized less $640,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during the partnership's fourth taxable year is $290,000 ($360,000 of minimum gain at the end of the fourth year less $70,000 of minimum gain at the end of the third year). Because the partnership did not distribute any of the proceeds of the loan it obtained in its fourth year during that year, the potential amount of partnership nonrecourse deductions for that year is $290,000. Under paragraph (c) of this section, if the partnership had distributed the proceeds of that loan to its partners at the end of its fourth year, the partnership's nonrecourse deductions for that year would have been reduced by the amount of that distribution because the proceeds of that loan are allocable to an increase in partnership minimum gain under paragraph (h)(1) of this section. Because the nonrecourse deductions of $290,000 for the partnership's fourth taxable year exceed its total deductions for that year, all $180,000 of the partnership's deductions for that year are treated as nonrecourse deductions, and the $110,000 excess nonrecourse deductions are treated as an increase in partnership minimum gain in the partnership's fifth taxable year under paragraph (c) of this section.

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at end of year 3 (including cash flow distributions)</td>
<td>($63,000)</td>
<td>($7,000)</td>
</tr>
<tr>
<td>Plus: rental income in year 4</td>
<td>85,500</td>
<td>9,500</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 4</td>
<td>(162,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Less: cash flow distributions in year 4</td>
<td>(4,500)</td>
<td>(500)</td>
</tr>
<tr>
<td>Capital account at end of year 4</td>
<td>($144,000)</td>
<td>($16,000)</td>
</tr>
</tbody>
</table>

At the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are $225,000 and $25,000, respectively (because the $110,000 excess of nonrecourse deductions is carried forward to the next year). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fifth taxable year, the partnership would realize $450,000 of gain ($1,000,000 amount realized less $550,000 adjusted tax basis). Therefore, the net increase in partnership minimum gain during the partnership's fifth taxable year is $200,000 ($110,000 deemed increase plus the $90,000 by which minimum gain at the end of the fifth year exceeds minimum gain at the end of the fourth year ($450,000 less $360,000)). At the beginning of its fifth year, the partnership distributes $180,000 of the loan proceeds (retaining $20,000 to pay the additional interest expense). Under paragraph (h) of this section, the first $110,000 of this distribution (an amount equal to the deemed increase in partnership minimum gain for the year) is considered allocable to an increase in partnership minimum gain for the year. As a result, the amount of nonrecourse deductions for the partnership's fifth taxable year is $90,000 ($200,000 net increase in minimum gain less $110,000 distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain), and the nonrecourse deductions consist solely of the $90,000 depreciation deduction allowable with respect to the building. As a result of the
distributions during the partnership’s fifth taxable year, the total distributions to the partners over the partnership’s life equal $205,000. Therefore, the last $5,000 distributed to the partners during the fifth year will be divided equally between them under the partnership agreement. Thus, out of the $185,000 total distribution during the partnership’s fifth taxable year, the first $180,000 is distributed 90 percent to LP and 10 percent to GP, and the last $5,000 is divided equally between them.

<table>
<thead>
<tr>
<th>Capital account at end of year 4</th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>($144,000)</td>
<td>($16,000)</td>
<td></td>
</tr>
<tr>
<td>Less: net loss in year 5 (without nonrecourse deductions)</td>
<td>(13,500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 5</td>
<td>(81,000)</td>
<td>(9,000)</td>
</tr>
<tr>
<td>Less: distribution of loan proceeds</td>
<td>(162,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Less: cash flow distribution in year 5</td>
<td>(2,500)</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Capital account at end of year 5</td>
<td>($403,000)</td>
<td>($47,000)</td>
</tr>
</tbody>
</table>

At the end of the partnership’s fifth taxable year, LP’s share of partnership minimum gain is $405,000 ($225,000 share of minimum gain at the end of the fourth year plus $81,000 of nonrecourse deductions for the fifth year and a $98,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain) and GP’s share of partnership minimum gain is $45,000 ($25,000 share of minimum gain at the end of the fourth year plus $9,000 of nonrecourse deductions for the fifth year and an $11,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain).

(vii) PARTNER GUARANTEE OF NONRECOURSE DEBT.

LP and GP personally guarantee the “first” $100,000 of the $800,000 nonrecourse loan (i.e., only if the building is worth less than $100,000 will they be called upon to make up any deficiency). Under paragraph (d)(2) of this section, only $630,000 of the adjusted tax basis of the building is allocated to the $700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the $100,000 guaranteed portion, making it superior in priority to the remainder of the loan. On the other hand, if LP and GP were to guarantee the “last” $100,000 (i.e., if the building is worth less than $800,000, they will be called upon to make up the deficiency up to $100,000), $700,000 of the adjusted tax basis of the building would be allocated to the $700,000 nonrecourse portion of the loan because the guaranteed portion would be inferior in priority to it.

(viii) PARTNER NONRECOURSE DEBT.

Assume instead that the $800,000 loan is made by LP, the limited partner. Under paragraph (b)(4) of this section, the $800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this section because LP, a partner, bears the economic risk of loss for that loan within the meaning of section 1.752-2. Instead, the $800,000 loan constitutes a partner nonrecourse debt under paragraph (b)(4) of this section. In the partnership’s third taxable year, partnership minimum gain would have increased by $70,000 if the debt were a nonrecourse liability of the partnership. Thus, under paragraph (i)(3) of this section, there is a net increase of $70,000 in the minimum gain attributable to the $800,000 partner nonrecourse debt for the partnership’s third taxable year, and $70,000 of the $90,000 depreciation deduction from the building for the partnership’s third taxable
year constitutes a partner nonrecourse deduction with respect to the debt. See paragraph (i)(4) of this section. Under paragraph (i)(2) of this section, this partner nonrecourse deduction must be allocated to LP, the partner that bears the economic risk of loss for that liability.

(ix) NONRECOурсUE DEBT AND PARTNER NONRECOурсUE DEBT OF DIFFERING PRIORITIES.

As in Example 1 (viii) of this paragraph (m), the $800,000 loan is made to the partnership by LP, the limited partner, but the loan is a purchase money loan that "wraps around" a $700,000 underlying nonrecourse note (also secured by the building) issued by LP to an unrelated person in connection with LP’s acquisition of the building. Under these circumstances, LP bears the economic risk of loss with respect to only $100,000 of the liability within the meaning of section 1.752-2. See section 1.752-2(f) (Example 6). Therefore, for purposes of paragraph (d) of this section, the $800,000 liability is treated as a $700,000 nonrecourse liability of the partnership and a $100,000 partner nonrecourse debt (inferior in priority to the $700,000 liability) of the partnership for which LP bears the economic risk of loss. Under paragraph (i)(2) of this section, $70,000 of the $90,000 depreciation deduction realized in the partnership’s third taxable year constitutes a partner nonrecourse deduction that must be allocated to LP.

EXAMPLE 2. NETTING OF INCREASES AND DECREASES IN PARTNERSHIP MINIMUM GAIN. For Example 2 unless otherwise provided, the following facts are assumed. X and Y form a general partnership to acquire and operate residential real properties. Each partner contributes $150,000 to the partnership. The partnership obtains a $1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for $720,000 ("Property A"), $540,000 ("Property B"), and $540,000 ("Property C"). The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership’s first 3 taxable years, it generates rental income of $225,000, operating expenses (including land lease payments) of $50,000, interest expense of $175,000, and depreciation deductions on the 3 properties of $150,000 ($60,000 on Property A and $45,000 on each of Property B and Property C), resulting in a net taxable loss of $150,000 in each of those years. The partnership makes no distributions to X or Y.

(i) CALCULATION OF NET INCREASES AND DECREASES IN PARTNERSHIP MINIMUM GAIN.

If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year, it would realize $150,000 of gain ($1,500,000 amount realized less $1,350,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $150,000, the amount of partnership nonrecourse deductions for that year is $150,000, consisting of depreciation deductions allowable with respect to the 3 apartment buildings of $150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were "cross-collateralized" (i.e., if each separate loan were secured by all 3 of the apartment buildings).
At the beginning of the partnership's fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for $835,000 and uses a portion of the proceeds to repay $600,000 of the nonrecourse liability (the principal amount attributable to Property A), reducing the balance to $900,000. As a result of the disposition, the partnership realizes gain of $295,000 ($835,000 amount realized less $540,000 adjusted tax basis). If the disposition is viewed in isolation, the partnership has generated minimum gain of $60,000 on the sale of Property A ($600,000 of debt reduction less $540,000 adjusted tax basis). However, during the partnership's fourth taxable year it also generates rental income of $135,000, operating expenses of $30,000, interest expense of $105,000, and depreciation deductions of $90,000 ($45,000 on each remaining building). If the partnership were to dispose of the remaining two buildings in full satisfaction of its nonrecourse liability at the end of the partnership's fourth taxable year, it would realize gain of $180,000 ($900,000 amount realized less $720,000 aggregate adjusted tax basis), which is the amount of partnership minimum gain at the end of the year. Because the partnership minimum gain increased from $150,000 to $180,000 during the partnership's fourth taxable year, the amount of partnership nonrecourse deductions for that year is $30,000, consisting of a ratable portion of depreciation deductions allowable with respect to the two remaining apartment buildings. No minimum gain chargeback is required for the taxable year, even though the partnership disposed of one of the properties subject to the nonrecourse liability during the year, because there is no net decrease in partnership minimum gain for the year. See paragraph (f)(1) of this section.
liability to $750,000. Allocations of these losses equally between A and B have substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: net loss in year 1</td>
<td>(50,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Capital account at end of year 1</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

In the partnership's second taxable year, it generates rental income of $130,000, interest expense of $75,000, and a depreciation deduction of $220,000, resulting in a net taxable loss of $165,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $700,000, and distributes $2,500 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($700,000 amount realized less $630,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is $70,000, and the amount of partnership nonrecourse deductions for the year is $70,000. The partnership nonrecourse deductions for its second taxable year consist of $70,000 of the depreciation deductions allowable with respect to the machinery. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $165,000, including the $70,000 nonrecourse deduction, are allocated equally between A and B. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account at end of year 1</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less: net loss in year 2 (without nonrecourse deductions)</td>
<td>(47,500)</td>
<td>(47,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 1</td>
<td>(35,000)</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Less: distribution</td>
<td>(2,500)</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Capital account at end of year 2</td>
<td>($35,000)</td>
<td>($35,000)</td>
</tr>
</tbody>
</table>

(i) Calculation of Nonrecourse Deductions and Partnership Minimum Gain.

Because all of the requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's second taxable year, A's and B's shares of partnership minimum gain are $35,000 each. Therefore, pursuant to paragraph (g)(1) of this section, A and B are treated as obligated to restore deficit balances in their capital accounts of $35,000 each. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the beginning of the partnership's third taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero. A's and B's shares of that net decrease would be $35,000 each. Upon that disposition, the minimum gain chargeback would require that A and B each be allocated $35,000 of that gain before any other allocation is made under section 704(b) with respect to partnership items for the partnership's third taxable year.
(ii) NONRECOURSE DEDUCTIONS AND RESTATEMENT OF CAPITAL ACCOUNTS.

(a) ADDITIONAL FACTS.

C is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of C's admission, the fair market value of the machinery is $900,000. C contributes $100,000 to the partnership (the partnership invests $95,000 of this in undeveloped land and holds the other $5,000 in cash) in exchange for an interest in the partnership. In connection with C's admission to the partnership, the partnership's machinery is revalued on the partnership's books to reflect its fair market value of $900,000. Pursuant to section 1.704-1(b)(2)(iv)(f), the capital accounts of A and B are adjusted upwards to $100,000 each to reflect the revaluation of the partnership's machinery. This adjustment reflects the manner in which the partnership gain of $270,000 ($500,000 fair market value minus $630,000 adjusted tax basis) would be shared if the machinery were sold for its fair market value immediately prior to C's admission to the partnership.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account before C's admission</td>
<td>($35,000)</td>
<td>($35,000)</td>
</tr>
<tr>
<td>Deemed sale adjustment</td>
<td>135,000</td>
<td>135,000</td>
</tr>
<tr>
<td>Capital account adjusted for C's admission</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between the property's $630,000 adjusted tax basis and its $900,000 book value, in accordance with section 1.704-1(b)(2)(iv)(f) and the special rule contained in section 1.704-1(b)(4)(i).

(b) EFFECT OF REVALUATION.

Because the requirements of section 1.704-1(b)(2)(iv)(g) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with section 1.704-1(b)(2)(iv). If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain ($700,000 amount realized less $900,000 book value). As a result of the revaluation of the machinery upward by $270,000, under part (i) of paragraph (d)(4) of this section, the partnership minimum gain is reduced from $70,000 immediately prior to the revaluation to zero; but under part (ii) of paragraph (d)(4) of this section, the partnership minimum gain is increased by the $70,000 decrease arising solely from the revaluation. Accordingly, there is no net increase or decrease solely on account of the revaluation, and so no minimum gain chargeback is triggered. All future nonrecourse deductions that occur will be the nonrecourse deductions as calculated for book purposes, and will be charged to all 3 partners in accordance with the partnership agreement. For purposes of determining
the partners’ shares of minimum gain under paragraph (g) of this section, A’s and B’s shares of the decrease resulting from the revaluation are $35,000 each. However, as illustrated below, under section 704(c) principles, the tax capital accounts of A and B will eventually be charged $35,000 each, reflecting their 50 percent shares of the decrease in partnership minimum gain that resulted from the revaluation.

(iii) ALLOCATION OF NONRECOUPSE DEDUCTIONS FOLLOWING RESTATEMENT OF CAPITAL ACCOUNTS.

(a) ADDITIONAL FACTS.

During the partnership's third taxable year, the partnership generates rental income of $130,000, interest expense of $70,000, a tax depreciation deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $150,000 and a net book loss of $240,000. In addition, the partnership repays $50,000 of the nonrecourse liability (after the date of C’s admission), reducing the liability to $650,000, and distributes $5,000 of cash to each partner.

(b) ALLOCATIONS.

If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $50,000 of book gain would result ($650,000 amount realized less $600,000 book basis). Therefore, the amount of partnership minimum gain at the end of the year is $50,000, which represents a net decrease in partnership minimum gain of $20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to paragraph (d)(4) of this section, the amount of nonrecourse deductions of the partnership for its third taxable year is $50,000 (the net increase in partnership minimum gain during the year determined by adding back the $70,000 decrease in partnership minimum gain attributable to the revaluation of the machinery to the $20,000 net decrease in partnership minimum gain during the year). The $50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of $50,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $240,000, including the $50,000 nonrecourse deduction, are allocated equally among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in section 1.704-1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of $210,000 for the partnership's third taxable year is, in accordance with section 704(c) principles, shared $55,000 to A, $55,000 to B, and $100,000 to C.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>($35,000)</td>
<td>($35,000)</td>
<td>($35,000)</td>
</tr>
<tr>
<td>Book</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Capital account at beginning of year 3

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: nonrecourse</td>
<td>(9,166)</td>
<td>(9,166)</td>
<td>(9,166)</td>
</tr>
<tr>
<td>(9,166)</td>
<td>(16,666)</td>
<td>(16,666)</td>
<td>(16,666)</td>
</tr>
</tbody>
</table>
Because the requirements of paragraph (e) of this section are satisfied, the allocation of the nonrecourse deduction is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, A's, B's, and C's shares of partnership minimum gain are $16,666 each.

(iv) SUBSEQUENT ALLOCATION OF NONRECIOURSE DEDUCTIONS FOLLOWING RESTATEMENT OF CAPITAL ACCOUNTS.

(a) ADDITIONAL FACTS.

The partners' capital accounts at the end of the second and third taxable years of the partnership are as stated in Example 3 (iii) of this paragraph (m). In addition, during the partnership's fourth taxable year the partnership generates rental income of $130,000, interest expense of $65,000, a tax depreciation deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $145,000 and a net book loss of $235,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $600,000, and distributes $5,000 of cash to each partner.

(b) ALLOCATIONS.

If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the fourth year, $300,000 of book gain would result ($600,000 amount realized less $300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is $300,000, which represents a net increase in partnership minimum gain during the year of $250,000. Thus, the amount of partnership nonrecourse deductions for that year equals $250,000, consisting of book depreciation deductions of $250,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $235,000, including the $250,000 nonrecourse deduction, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in section 1.704-1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of $210,000 in the Partnership's fourth taxable year is, in accordance with section 704(c) principles, allocated $55,000 to A, $55,000 to B, and $100,000 to C.
The allocation of the $250,000 nonrecourse deduction equally among A, B, and C satisfies requirement (2) of paragraph (e) of this section. Because all of the requirements of paragraph (e) of this section are satisfied, the allocation is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's fourth taxable year, A's, B's, and C's shares of partnership minimum gain are $100,000 each.

(v) DISPOSITION OF PARTNERSHIP PROPERTY FOLLOWING RESTATEMENT OF CAPITAL ACCOUNTS.

(a) Additional facts.

The partners' capital accounts at the end of the fourth taxable year of the partnership are as stated above in (iv). In addition, at the beginning of the partnership's fifth taxable year it sells the machinery for $650,000 (using $600,000 of the proceeds to repay the nonrecourse liability), resulting in a taxable gain of $440,000 ($650,000 amount realized less $210,000 adjusted tax basis) and a book gain of $350,000 ($650,000 amount realized less $300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for the year.

(b) EFFECT OF DISPOSITION.

As a result of the sale, partnership minimum gain is reduced from $300,000 to zero, reducing A's, B's, and C's shares of partnership minimum gain to zero from $100,000 each. The minimum gain chargeback requires that A, B, and C each be allocated $100,000 of that gain (an amount equal to each partner's share of the net decrease in partnership minimum gain resulting from the sale) before any allocation is made to them under section 704 (b) with respect to partnership items for the partnership's fifth taxable year. Thus, the allocation of the first $300,000 of book gain $100,000 to each of the partners is deemed to be in accordance with the partners' interests in the partnership under paragraph (e) of this section. The allocation of the remaining $50,000 of book gain equally among the partners has substantial

<table>
<thead>
<tr>
<th>Capital account at beginning of year 4</th>
<th>($75,000)</th>
<th>$15,000</th>
<th>($75,000)</th>
<th>$15,000</th>
<th>$15,000</th>
<th>$15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus: items other than nonrecourse deductions in year 4</td>
<td>12,499</td>
<td>5,000</td>
<td>12,499</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Less: distribution</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Capital account at end of year 4</td>
<td>($113,334)</td>
<td>($68,333)</td>
<td>($113,334)</td>
<td>($68,333)</td>
<td>($68,333)</td>
<td>($68,333)</td>
</tr>
</tbody>
</table>
economic effect. Consistent with the special partners' interests in the partnership rule contained in section 1.704-1(b)(4)(i), the partnership agreement provides that the $440,000 taxable gain is, in accordance with section 704(c) principles, allocated $161,667 to A, $161,667 to B, and $116,666 to C.

<table>
<thead>
<tr>
<th>Capital account at beginning of year 4</th>
<th>Tax (A)</th>
<th>Book (B)</th>
<th>Tax (C)</th>
<th>Book (C)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($113,334)</td>
<td>($68,333)</td>
<td>($113,334)</td>
<td>($68,333)</td>
</tr>
<tr>
<td>Plus: minimum chargeback</td>
<td>138,573</td>
<td>100,000</td>
<td>138,573</td>
<td>100,000</td>
</tr>
<tr>
<td>Plus: additional gain</td>
<td>23,094</td>
<td>16,666</td>
<td>23,094</td>
<td>16,666</td>
</tr>
<tr>
<td>Capital account before liquidation</td>
<td>$48,333</td>
<td>$48,333</td>
<td>$48,333</td>
<td>$48,333</td>
</tr>
</tbody>
</table>

**EXAMPLE (4). ALLOCATIONS OF INCREASE IN PARTNERSHIP MINIMUM GAIN AMONG PARTNERSHIP PROPERTIES.** For EXAMPLE 4, unless otherwise provided, the following facts are assumed. A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property W of $10,000 and repays $5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of $5,000. Second, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property X of $10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of $10,000. Third, the partnership generates a depreciation deduction (for both book and tax purposes) of $2,000 with respect to Property Y and repays $11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of $9,000 (although at the end of that year, there remains minimum gain with respect to that liability). Finally, the partnership borrows $5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, a parcel of undeveloped land with an adjusted tax basis (and book value) of $2,000, resulting in a net increase in minimum gain with respect to that liability of $3,000.

**(i) ALLOCATION OF INCREASE IN PARTNERSHIP MINIMUM GAIN.**

The net increase in partnership minimum gain during that partnership taxable year is $9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is $9,000. Those nonrecourse deductions consist of $3,000 of depreciation deductions with respect to Property W and $6,000 of depreciation deductions with respect to Property X. See paragraph (c) of this section. The
amount of nonrecourse deductions consisting of depreciation deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, for which there is no depreciation deduction, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is no increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are secured by property for which there are depreciation deductions and for which there is an increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is determined by the following formula:

\[
\text{Net increase in the partnership minimum gain for that taxable year} \times \frac{\text{Total depreciation deductions for that taxable year on the specific property securing the nonrecourse liability to the extent minimum gain increased on that liability}}{\text{Total depreciation deductions for that taxable year on all properties securing nonrecourse liabilities to the extent of the aggregate increase in minimum gain on all those liabilities}}
\]

Thus, for the liability secured by Property W, the amount is $9,000 times $5,000/$15,000, or $3,000. For the liability secured by Property X, the amount is $9,000 times $10,000/$15,000, or $6,000. (If one depreciable property secured two partnership nonrecourse liabilities, the amount of depreciation or book depreciation with respect to that property would be allocated among those liabilities in accordance with the method by which adjusted basis is allocated under paragraph (d)(2) of this section).

(ii) ALTERNATIVE ALLOCATION OF INCREASE IN PARTNERSHIP MINIMUM GAIN AMONG PARTNERSHIP PROPERTIES.

Assume instead that the loan secured by Property Z is $15,000 (rather than $5,000), resulting in a net increase in minimum gain with respect to that liability of $13,000. Thus, the net increase in partnership minimum gain is $19,000, and the amount of nonrecourse deductions of the partnership for that taxable year is $19,000. Those nonrecourse deductions consist of $5,000 of depreciation deductions with respect to Property W, $10,000 of depreciation deductions with respect to Property X, and a pro rata portion of the partnership’s other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. The method for computing the amounts of depreciation deductions that constitute nonrecourse deductions is the same as in (i) of this Example 4 for the liabilities secured by Properties Y and Z. With respect to each of the nonrecourse liabilities secured by Properties W and X, the amount of depreciation deductions that constitutes nonrecourse deductions equals the total depreciation deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability.

Sec. 1.704-3 Contributed property.

(a) In general --

(1) General principles.

The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (e.g., aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See section 1.704-3(d). Paragraph (e) of this section contains special rules and exceptions.

(2) Operating rules.

Except as provided in paragraphs (e)(2) and (e)(3) of this section, section 704(c) and this section apply on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated. A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of section 704(c). It may be unreasonable to use one method for appreciated property and another method for depreciated property. Similarly, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate. A new partnership formed as the result of the termination of a partnership under section 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to section 704(c) property deemed contributed to the new partnership by the terminated partnership under section 1.708-1(b)(1)(iv). The previous sentence applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentence may be applied to terminations occurring on or after May 9, 1996,
provided that the partnership and its partners apply the sentence to the termination in a consistent manner.

(3) Definitions --

(i) Section 704(c) property.

Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis. For purposes of this section, book value is determined as contemplated by section 1.704-1(b). Therefore, book value is equal to fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property. For a partnership that maintains capital accounts in accordance with section 1.704-1(b)(2)(iv), the book value of property is initially the value used in determining the contributing partner's capital account under section 1.704-1(b)(2)(iv)(d), and is appropriately adjusted thereafter (e.g., for book cost recovery under section section 1.704-1(b)(2)(iv)(g)(3) and 1.704-3(d)(2) and other events that affect the basis of the property). A partnership that does not maintain capital accounts under section 1.704-1(b)(2)(iv) must comply with this section using a book capital account based on the same principles (i.e., a book capital account that reflects the fair market value of property at the time of contribution and that is subsequently adjusted for cost recovery and other events that affect the basis of the property). Property deemed contributed to a new partnership as the result of the termination of a partnership under section 708(b)(1)(B) is treated as section 704(c) property in the hands of the new partnership only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination. See section 1.708-1(b)(1)(iv) for an example of the application of this rule. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(ii) Built-in gain and built-in loss.

The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis. The built-in loss on section 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted tax basis and book value.

(4) Accounts payable and other accrued but unpaid items.

Accounts payable and other accrued but unpaid items contributed by a partner using the cash receipts and disbursements method of accounting are treated as section 704(c) property for purposes of applying the rules of this section.
(5) Other provisions of the internal revenue code.

Section 704(c) and this section apply to a contribution of property to the partnership only if the contribution is governed by section 721, taking into account other provisions of the Internal Revenue Code. For example, to the extent that a transfer of property to a partnership is a sale under section 707, the transfer is not a contribution of property to which section 704(c) applies.

(6) Other applications of section 704(c) principles --

(i) Revaluations under section 704(b).

The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to section 1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations). Partnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c) and paragraph (a) of this section. In addition, partnerships are not required to use the same allocation method for reverse section 704(c) allocations each time the partnership revalues its property. A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of section 704(b) and (c).

(ii) Basis adjustments.

A partnership making adjustments under section 1.743-1(b) or 1.751-1(a)(2) must account for built-in gain or loss under section 704(c) in accordance with the principles of this section.

(7) Transfers of a partnership interest.

If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.

(8) Disposition of property in nonrecognition transaction.

If a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section
704(c) property had been the only property transferred to the corporation by the partnership.

(9) Tiered partnerships.

If a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Allocations made under this paragraph will be considered to be made in a manner that meets the requirements of section 1.704-1(b)(2)(iv)(q) (relating to capital account adjustments where guidance is lacking).

(10) Anti-abuse rule.

An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

(11) Contributing and noncontributing partners' recapture shares.

For special rules applicable to the allocation of depreciation recapture with respect to property contributed by a partner to a partnership, see sections 1.1245-1(e)(2) and 1.1250-1(f).

(b) Traditional method --

(1) In general.

This paragraph (b) describes the traditional method of making section 704(c) allocations. In general, the traditional method requires that when the partnership has income, gain, loss, or deduction attributable to section 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the partnership sells section 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner. If the partnership sells a portion of, or an interest in, section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner. For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners. However, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year.
(the ceiling rule). If a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

(2) Examples.

The following examples illustrate the principles of the traditional method.

**Example 1.** Operation of the traditional method --

(i) Calculation of built-in gain on contribution.

A and B form partnership AB and agree that each will be allocated a 50 percent share of all partnership items and that AB will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. A contributes depreciable property with an adjusted tax basis of $4,000 and a book value of $10,000, and B contributes $10,000 cash. Under paragraph (a)(3) of this section, A has built-in gain of $6,000, the excess of the partnership's book value for the property ($10,000) over A's adjusted tax basis in the property at the time of contribution ($4,000).

(ii) Allocation of tax depreciation.

The property is depreciated using the straight-line method over a 10-year recovery period. Because the property depreciates at an annual rate of 10 percent, B would have been entitled to a depreciation deduction of $500 per year for both book and tax purposes if the adjusted tax basis of the property equalled its fair market value at the time of contribution. Although each partner is allocated $500 of book depreciation per year, the partnership is allowed a tax depreciation deduction of only $400 per year (10 percent of $4,000). The partnership can allocate only $400 of tax depreciation under the ceiling rule of paragraph (b)(1) of this section, and it must be allocated entirely to B. In AB's first year, the proceeds generated by the equipment exactly equal AB's operating expenses. At the end of that year, the book value of the property is $9,000 ($10,000 less the $1,000 book depreciation deduction), and the adjusted tax basis is $3,600 ($4,000 less the $400 tax depreciation deduction). A's built-in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also, at the end of AB's first year, A has a $9,500 book capital account and a $4,000 tax basis in A's partnership interest. B has a $9,500 book capital account and a $9,600 adjusted tax basis in B's partnership interest.

(iii) Sale of the property.

If AB sells the property at the beginning of AB's second year for $9,000, AB realizes tax gain of $5,400 ($9,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, the entire $5,400 gain must be allocated to A because the property A contributed has that much built-in gain remaining. If AB sells the property at the beginning of AB's second year for $10,000, AB realizes tax gain of $6,400 ($10,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, only $5,400 of gain must be allocated to A to account for A's built-in gain. The remaining $1,000 of gain is allocated equally between A and B in accordance
with the partnership agreement. If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400, and the entire gain must be allocated to A.

(iv) Termination and liquidation of partnership.

If AB sells the property at the beginning of AB's second year for $9,000, and AB engages in no other transactions that year, A will recognize a gain of $5,400, and B will recognize no income or loss. A's adjusted tax basis for A's interest in AB will then be $9,400 ($4,000, A's original tax basis, increased by the gain of $5,400). B's adjusted tax basis for B's interest in AB will be $9,600 ($10,000, B's original tax basis, less the $400 depreciation deduction in the first partnership year). If the partnership then terminates and distributes its assets ($19,000 in cash) to A and B in proportion to their capital account balances, A will recognize a capital gain of $100 ($9,500, the amount distributed to A, less $9,400, the adjusted tax basis of A's interest). B will recognize a capital loss of $100 (the excess of B's adjusted tax basis, $9,600, over the amount received, $9,500).

Example 2. Unreasonable use of the traditional method --

(i) Facts.

C and D form partnership CD and agree that each will be allocated a 50 percent share of all partnership items and that CD will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. C contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. At the time of contribution, C has a built-in gain of $9,000 and the equipment is section 704(c) property. D contributes $10,000 of cash, which CD uses to buy securities. D has substantial net operating loss carryforwards that D anticipates will otherwise expire unused. Under section 1.704-1(b)(2)(iv)(g)(3), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. CD sells the equipment during the second year for $10,000 and recognizes a $10,000 gain ($10,000, the amount realized, less the adjusted tax basis of $0).

(ii) Unreasonable use of method --

(A) At the beginning of the second year, both the book value and adjusted tax basis of the equipment are $0. Therefore, there is no remaining built-in gain. The $10,000 gain on the sale of the equipment in the second year is allocated $5,000 each to C and D. The interaction of the partnership's one-year write-off of the entire book value of the equipment and the use of the traditional method results in a shift of $4,000 of the precontribution gain in the equipment from C to D (D's $5,000 share of CD's $10,000 gain, less the $1,000 tax depreciation deduction previously allocated to D).

(B) The traditional method is not reasonable under paragraph (a)(10) of this section because the contribution of property is made, and the traditional method is used, with a view to shifting a significant amount of taxable income to a
partner with a low marginal tax rate and away from a partner with a high marginal
tax rate.

(C) Under these facts, if the partnership agreement in effect for the year of
contribution had provided that tax gain from the sale of the property (if any)
would always be allocated first to C to offset the effect of the ceiling rule
limitation, the allocation method would not violate the anti-abuse rule of
paragraph (a)(10) of this section. See paragraph (c)(3) of this section. Under
other facts, (for example, if the partnership holds multiple section 704(c)
properties and either uses multiple allocation methods or uses a single allocation
method where one or more of the properties are subject to the ceiling rule) the
allocation to C may not be reasonable.

(c) Traditional method with curative allocations --

(1) In general.

To correct distortions created by the ceiling rule, a partnership using the
traditional method under paragraph (b) of this section may make reasonable
curative allocations to reduce or eliminate disparities between book and tax
items of noncontributing partners. A curative allocation is an allocation of
income, gain, loss, or deduction for tax purposes that differs from the
partnership's allocation of the corresponding book item. For example, if a
noncontributing partner is allocated less tax depreciation than book depreciation
with respect to an item of section 704(c) property, the partnership may make a
curative allocation to that partner of tax depreciation from another item of
partnership property to make up the difference, notwithstanding that the
Corresponding book depreciation is allocated to the contributing partner. A
partnership may limit its curative allocations to allocations of one or more
particular tax items (e.g., only depreciation from a specific property or properties)
even if the allocation of those available items does not offset fully the effect of
the ceiling rule.

(2) Consistency.

A partnership must be consistent in its application of curative allocations with
respect to each item of section 704(c) property from year to year.

(3) Reasonable curative allocations --

(i) Amount.

A curative allocation is not reasonable to the extent it exceeds the
amount necessary to offset the effect of the ceiling rule for the current
taxable year or, in the case of a curative allocation upon disposition of the
property, for prior taxable years.

(ii) Timing.

The period of time over which the curative allocations are made is a
factor in determining whether the allocations are reasonable. Notwithstanding
paragraph (c)(3)(i) of this section, a partnership may make curative
allocations in a taxable year to offset the effect of the ceiling rule for a prior
taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution. See paragraph (c)(4) Example 3(ii)(C) of this section.

(iii) Type --

(A) In general.

To be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The expectation must exist at the time the section 704(c) property is obligated to be (or is) contributed to the partnership and the allocation with respect to that property becomes part of the partnership agreement. However, the expectation is tested at the time the allocation with respect to that property is actually made if the partnership agreement is not sufficiently specific as to the precise manner in which allocations are to be made with respect to that property. Under this paragraph (c), if the item limited by the ceiling rule is loss from the sale of property, a curative allocation of gain must be expected to have substantially the same effect as would an allocation to that partner of gain with respect to the sale of the property. If the item limited by the ceiling rule is depreciation or other cost recovery, a curative allocation of income to the contributing partner must be expected to have substantially the same effect as would an allocation to that partner of partnership income with respect to the contributed property. For example, if depreciation deductions with respect to leased equipment contributed by a tax-exempt partner are limited by the ceiling rule, a curative allocation of dividend or interest income to that partner generally is not reasonable, although a curative allocation of depreciation deductions from other leased equipment to the noncontributing partner is reasonable. Similarly, under this rule, if depreciation deductions apportioned to foreign source income in a particular statutory grouping under section 904(d) are limited by the ceiling rule, a curative allocation of income from another statutory grouping to the contributing partner generally is not reasonable, although a curative allocation of income from the same statutory grouping and of the same character is reasonable.

(B) Exception for allocation from disposition of contributed property.

If cost recovery has been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule, but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation. For example, if allocations of depreciation deductions to a noncontributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property, if properly provided for in the partnership agreement, is reasonable for purposes of paragraph (c)(3)(iii)(A) of this section even if not of the same character.

(4) Examples.
The following examples illustrate the principles of this paragraph (c).

**Example 1.** Reasonable and unreasonable curative allocations --

(i) Facts.

E and F form partnership EF and agree that each will be allocated a 50 percent share of all partnership items and that EF will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. E contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The equipment has 10 years remaining on its cost recovery schedule and is depreciable using the straight-line method. At the time of contribution, E has a built-in gain of $6,000, and therefore, the equipment is section 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale. In EF's first year, the revenue generated by the equipment equals EF's operating expenses. The equipment generates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year EF sells all the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method of paragraph (b) of this section, E and F would each be allocated $350 of income from the sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would all be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>E Book</th>
<th>E Tax</th>
<th>F Book</th>
<th>F Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$10,000</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(500)</td>
<td>(0)</td>
<td>(500)</td>
<td>(400)</td>
</tr>
<tr>
<td>Sales income</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td>350</td>
</tr>
<tr>
<td></td>
<td>9,850</td>
<td>4,350</td>
<td>9,850</td>
<td>9,950</td>
</tr>
</tbody>
</table>

(ii) Reasonable curative allocation.

Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E under paragraph (c) of this section an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

<table>
<thead>
<tr>
<th></th>
<th>E Book</th>
<th>E Tax</th>
<th>F Book</th>
<th>F Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$10,000</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(500)</td>
<td>(0)</td>
<td>(500)</td>
<td>(400)</td>
</tr>
<tr>
<td>Sales income</td>
<td>350</td>
<td>450</td>
<td>350</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>9,850</td>
<td>4,450</td>
<td>9,850</td>
<td>9,850</td>
</tr>
</tbody>
</table>

(iii) Unreasonable curative allocation.
(A) The facts are the same as in paragraphs (i) and (ii) of this Example 1, except that E and F choose to allocate all the income from the sale of the inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF’s first year as follows:

<table>
<thead>
<tr>
<th></th>
<th>E Book</th>
<th>E Tax</th>
<th>F Book</th>
<th>F Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$10,000</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(500)</td>
<td>(0)</td>
<td>(500)</td>
<td>(400)</td>
</tr>
<tr>
<td>Sales income</td>
<td>350</td>
<td>700</td>
<td>350</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>9,850</td>
<td>4,700</td>
<td>9,850</td>
<td>9,600</td>
</tr>
</tbody>
</table>

(B) This curative allocation is not reasonable under paragraph (c)(3)(i) of this section because the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule.

Example 2. Curative allocations limited to depreciation --

(i) Facts.

G and H form partnership GH and agree that each will be allocated a 50 percent share of all partnership items and that GH will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section, but only to the extent that the partnership has sufficient tax depreciation deductions. G contributes property G1, with an adjusted tax basis of $3,000 and a fair market value of $10,000, and H contributes property H1, with an adjusted tax basis of $6,000 and a fair market value of $10,000. Both properties have 5 years remaining on their cost recovery schedules and are depreciable using the straight-line method. At the time of contribution, G1 has a built-in gain of $7,000 and H1 has a built-in gain of $4,000, and therefore, both properties are section 704(c) property. G1 generates $600 of tax depreciation and $2,000 of book depreciation for each of five years. H1 generates $1,200 of tax depreciation and $2,000 of book depreciation for each of 5 years. In addition, the properties each generate $500 of operating income annually. G and H are each allocated $1,000 of book depreciation for each property. Under the traditional method of paragraph (b) of this section, G would be allocated $0 of tax depreciation for G1 and $1,000 for H1, and H would be allocated $600 of tax depreciation for G1 and $200 for H1. Thus, at the end of the first year, G and H’s book and tax capital accounts would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>G Book</th>
<th>G Tax</th>
<th>H Book</th>
<th>H Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$10,000</td>
<td>$3,000</td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>G1 Depreciation</td>
<td>(1,000)</td>
<td>(0)</td>
<td>(1,000)</td>
<td>(600)</td>
</tr>
<tr>
<td>H1 Depreciation</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(200)</td>
</tr>
<tr>
<td>Operating income</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>$8,500</td>
<td>$2,500</td>
<td>$8,500</td>
<td>$5,700</td>
</tr>
</tbody>
</table>

(ii) Curative allocations.
Under the traditional method, G is allocated more depreciation deductions than H, even though H contributed property with a smaller disparity reflected on GH’s book and tax capital accounts. GH makes curative allocations to H of an additional $400 of tax depreciation each year, which reduces the disparities between G and H’s book and tax capital accounts ratably each year. These allocations are reasonable provided the allocations meet the other requirements of this section. As a result of their agreement, at the end of the first year, G and H’s capital accounts are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td>$10,000</td>
<td>$3,000</td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
<tr>
<td></td>
<td>(1,000)</td>
<td>(0)</td>
<td>(1,000)</td>
<td>(600)</td>
</tr>
<tr>
<td></td>
<td>(1,000)</td>
<td>(600)</td>
<td>(1,000)</td>
<td>(600)</td>
</tr>
<tr>
<td></td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>$8,500</td>
<td>$2,900</td>
<td>$8,500</td>
<td>$5,300</td>
</tr>
</tbody>
</table>

**Example 3. Unreasonable use of curative allocations --**

(i) **Facts.**

J and K form partnership JK and agree that each will receive a 50 percent share of all partnership items and that JK will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. J contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although it has an estimated remaining economic life of 10 years. J has substantial net operating loss carryforwards that J anticipates will otherwise expire unused. At the time of contribution, J has a built-in gain of $9,000, and therefore, the equipment is section 704(c) property. K contributes $10,000 of cash, which JK uses to buy inventory for resale. In JK’s first year, the revenues generated by the equipment exactly equal JK’s operating expenses. Under section 1.704-1(b)(2)(iv)(g)(3), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership’s first year. In addition, at the end of the first year JK sells all of the inventory for $18,000, recognizing $8,000 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from J’s contributed equipment. Under the traditional method of paragraph (b) of this section, J and K’s book and tax capital accounts at the end of the first year would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>J</td>
<td>$10,000</td>
<td>$1,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>(5,000)</td>
<td>(0)</td>
<td>(5,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td></td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>$9,000</td>
<td>$5,000</td>
<td>$9,000</td>
<td>$13,000</td>
</tr>
</tbody>
</table>
(ii) Unreasonable use of method.

(A) The use of curative allocations under these facts to offset immediately the full effect of the ceiling rule would result in the following book and tax capital accounts at the end of JK’s first year:

<table>
<thead>
<tr>
<th></th>
<th>J</th>
<th>K</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$1,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Book</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$1,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Initial contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$9,000</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

(B) This curative allocation is not reasonable under paragraph (a)(10) of this section because the contribution of property is made and the curative allocation method is used with a view to shifting a significant amount of partnership taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate, within a period of time significantly shorter than the economic life of the property.

(C) The property has only one year remaining on its cost recovery schedule even though its economic life is considerably longer. Under these facts, if the partnership agreement had provided for curative allocations over a reasonable period of time, such as over the property’s economic life, rather than over its remaining cost recovery period, the allocations would have been reasonable. See paragraph (c)(3)(ii) of this section. Thus, in this example, JK would make a curative allocation of $400 of sales income to J in the partnership’s first year (10 percent of $4,000). J and K’s book and tax capital accounts at the end of the first year would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>J</th>
<th>K</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$1,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Book</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$1,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Initial contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$9,000</td>
<td>$9,400</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

(d) Remedial allocation method --

(1) In general.

A partnership may adopt the remedial allocation method described in this paragraph to eliminate distortions caused by the ceiling rule. A partnership adopting the remedial allocation method eliminates those distortions by creating remedial items and allocating those items to its partners. Under the remedial allocation method, the partnership first determines the amount of book items under paragraph (d)(2) of this section and the partners’ distributive shares of these items under section 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method described in paragraph (b)(1) of this section. If the ceiling rule (as defined in paragraph (b)(1) of this section) causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item
to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

(2) Determining the amount of book items.

Under the remedial allocation method, a partnership determines the amount of book items attributable to contributed property in the following manner rather than under the rules of section 1.704-1(b)(2)(iv)(g)(3). The portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered (generally, over the property's remaining recovery period under section 168(i)(7) or other applicable Internal Revenue Code section). The remainder of the partnership's book basis in the property (the amount by which book basis exceeds adjusted tax basis) is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution.

(3) Type.

Remedial allocations of income, gain, loss, or deduction to the noncontributing partner have the same tax attributes as the tax item limited by the ceiling rule. The tax attributes of offsetting remedial allocations of income, gain, loss, or deduction to the contributing partner are determined by reference to the item limited by the ceiling rule. Thus, for example, if the ceiling rule limited item is loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be gain from the sale of that property. Conversely, if the ceiling rule limited item is gain from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be loss from the sale of that property. If the ceiling rule limited item is depreciation or other cost recovery from the contributed property, the offsetting remedial allocation to the contributing partner must be income of the type produced (directly or indirectly) by that property. Any partner level tax attributes are determined at the partner level. For example, if the ceiling rule limited item is depreciation from property used in a rental activity, the remedial allocation to the noncontributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies section 469 to the allocations as appropriate.

(4) Effect of remedial items --

(i) Effect on partnership.

Remedial items do not affect the partnership's computation of its taxable income under section 703 and do not affect the partnership's adjusted tax basis in partnership property.

(ii) Effect on partners.
Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest.

(5) Limitations on use of methods involving remedial allocations --

(i) Limitation on taxpayers.

In the absence of published guidance, the remedial allocation method described in this paragraph (d) is the only reasonable section 704(c) method permitting the creation of notional tax items.

(ii) Limitation on Internal Revenue Service.

In exercising its authority under paragraph (a)(10) of this section to make adjustments if a partnership's allocation method is not reasonable, the Internal Revenue Service will not require a partnership to use the remedial allocation method described in this paragraph (d) or any other method involving the creation of notional tax items.

(6) Adjustments to application of method.

The Commissioner may, by published guidance, prescribe adjustments to the remedial allocation method under this paragraph (d) as necessary or appropriate. This guidance may, for example, prescribe adjustments to the remedial allocation method to prevent the duplication or omission of items of income or deduction or to reflect more clearly the partners' income or the income of a transferee of a partner.

(7) Examples.

The following examples illustrate the principles of this paragraph (d).

Example 1. Remedial allocation method --

(i) Facts.

On January 1, L and M form partnership LM and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under this paragraph (d) and that the straight-line method will be used to recover excess book basis. L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000, which the partnership uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year the partnership is formed.

(ii) Years 1 through 4.

Under the remedial allocation method of this paragraph (d), LM has book depreciation for each of its first 4 years of $1,600 [$1,000 ($4,000 adjusted tax basis divided by the 4-year remaining recovery period) plus $600 ($6,000 excess
of book value over tax basis, divided by the NEW 10-year recovery period). (For
the purpose of simplifying the example, the partnership's book depreciation is
determined without regard to any first-year depreciation conventions.) Under the
partnership agreement, L and M are each allocated 50 percent ($800) of the
book depreciation. M is allocated $800 of tax depreciation and L is allocated the
remaining $200 of tax depreciation ($1,000 - $800). See paragraph (d)(1) of this
section. No remedial allocations are made because the ceiling rule does not
result in a book allocation of depreciation to M different from the tax allocation.
The allocations result in capital accounts at the end of LM's first 4 years as
follows:

<table>
<thead>
<tr>
<th></th>
<th>L Book</th>
<th>L Tax</th>
<th>M Book</th>
<th>M Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$10,000</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(3,200)</td>
<td>(800)</td>
<td>(3,200)</td>
<td>(3,200)</td>
</tr>
<tr>
<td>$6,800</td>
<td>$3,200</td>
<td>$6,800</td>
<td>$6,800</td>
<td></td>
</tr>
</tbody>
</table>

(iii) Subsequent years.

(A) For each of years 5 through 10, LM has $600 of book depreciation ($6,000
excess of initial book value over adjusted tax basis divided by the 10-year
recovery period that commented in year 1), but no tax depreciation. Under
the partnership agreement, the $600 of book depreciation is allocated equally
to L and M. Because of the application of the ceiling rule in year 5, M would
be allocated $300 of book depreciation, but no tax depreciation. Thus, at the
end of LM's fifth year L's and M's book and tax capital accounts would be as
follows:

<table>
<thead>
<tr>
<th></th>
<th>L Book</th>
<th>L Tax</th>
<th>M Book</th>
<th>M Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>End of year 4</td>
<td>$6,800</td>
<td>$3,200</td>
<td>$6,800</td>
<td>$6,800</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(300)</td>
<td>(300)</td>
<td>(300)</td>
<td></td>
</tr>
<tr>
<td>$6,500</td>
<td>$3,200</td>
<td>$6,500</td>
<td>$6,800</td>
<td></td>
</tr>
</tbody>
</table>

(B) Because the ceiling rule would cause an annual disparity of $300 between
M's allocations of book and tax depreciation, LM must make remedial allocations
of $300 of tax depreciation deductions to M under the remedial allocation method
for each of years 5 through 10. LM must also make an offsetting remedial
allocation to L of $300 of taxable income, which must be of the same type as
income produced by the property. At the end of year 5, LM's capital accounts are
as follows:

<table>
<thead>
<tr>
<th></th>
<th>L Book</th>
<th>L Tax</th>
<th>M Book</th>
<th>M Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>End of year 4</td>
<td>$6,800</td>
<td>$3,200</td>
<td>$6,800</td>
<td>$6,800</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(300)</td>
<td>(300)</td>
<td>(300)</td>
<td></td>
</tr>
<tr>
<td>$6,500</td>
<td>$3,500</td>
<td>$6,500</td>
<td>$6,500</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>L Book</th>
<th>L Tax</th>
<th>M Book</th>
<th>M Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remedial allocations</td>
<td>(300)</td>
<td>(300)</td>
<td>(300)</td>
<td></td>
</tr>
<tr>
<td>$6,500</td>
<td>$3,500</td>
<td>$6,500</td>
<td>$6,500</td>
<td></td>
</tr>
</tbody>
</table>
(C) At the end of year 10, LM's capital accounts are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>L</th>
<th>Tax</th>
<th>M</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,500</td>
<td>1,500</td>
<td>$6,500</td>
<td>1,500</td>
<td>$6,500</td>
<td>1,500</td>
</tr>
<tr>
<td>End of year 5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$5,000</td>
<td>1,500</td>
<td>$5,000</td>
<td>1,500</td>
<td>$5,000</td>
<td>1,500</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$5,000</td>
<td>1,500</td>
<td>$5,000</td>
<td>1,500</td>
<td>$5,000</td>
<td>1,500</td>
</tr>
<tr>
<td>Remedial allocations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Example 2. Remedial allocations on sale** --

(i) **Facts.**

N and P form partnership NP and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that NP will make allocations under section 704(c) using the remedial allocation method under this paragraph (d). N contributes Blackacre (land) with an adjusted tax basis of $4,000 and a fair market value of $10,000. Because N has a built-in gain of $6,000, Blackacre is section 704(c) property. P contributes Whiteacre (land) with an adjusted tax basis and fair market value of $10,000. At the end of NP's first year, NP sells Blackacre to Q for $9,000 and recognizes a capital gain of $5,000 ($9,000 amount realized less $4,000 adjusted tax basis) and a book loss of $1,000 ($9,000 amount realized less $10,000 book basis). NP has no other items of income, gain, loss, or deduction. If the ceiling rule were applied, N would be allocated the entire $5,000 of tax gain and N and P would each be allocated $500 of book loss. Thus, at the end of NP's first year N's and P's book and tax capital accounts would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$4,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Sale of Blackacre</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Book</td>
<td>$5,000</td>
<td>$500</td>
</tr>
<tr>
<td>Tax</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Initial contribution</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(ii) **Remedial allocation.**

Because the ceiling rule would cause a disparity of $500 between P’s allocation of book and tax loss, NP must make a remedial allocation of $500 of capital loss to P and an offsetting remedial allocation to N of an additional $500 of capital gain. These allocations result in capital accounts at the end of NP’s first year as follows:

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$4,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Sale of Blackacre</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Book</td>
<td>$5,000</td>
<td>$500</td>
</tr>
<tr>
<td>Tax</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Remedial allocations</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Example 3. Remedial allocation where built-in gain property sold for book and tax loss --

(i) Facts.

The facts are the same as in Example 2, except that at the end of NP's first year, NP sells Blackacre to Q for $3,000 and recognizes a capital loss of $1,000 ($3,000 amount realized less $4,000 adjusted tax basis) and a book loss of $7,000 ($3,000 amount realized less $10,000 book basis). If the ceiling rule were applied, P would be allocated the entire $1,000 of tax loss and N and P would each be allocated $3,500 of book loss. Thus, at the end of NP's first year, N's and P's book and tax capital accounts would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>$10,000</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>P</td>
<td>(3,500)</td>
<td>0</td>
<td>(3,500)</td>
<td>(1,000)</td>
</tr>
<tr>
<td></td>
<td>$6,500</td>
<td>$4,000</td>
<td>$6,500</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

(ii) Remedial allocation.

Because the ceiling rule would cause a disparity of $2,500 between P's allocation of book and tax loss on the sale of Blackacre, NP must make a remedial allocation of $2,500 of capital loss to P and an offsetting remedial allocation to N of $2,500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>$10,000</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>P</td>
<td>2,500</td>
<td>(2,500)</td>
<td>2,500</td>
<td>(2,500)</td>
</tr>
<tr>
<td></td>
<td>$6,500</td>
<td>$6,500</td>
<td>$6,500</td>
<td>$6,500</td>
</tr>
</tbody>
</table>

(e) Exceptions and special rules --

(1) Small disparities --

(i) General rule.

If a partner contributes one or more items of property to a partnership within a single taxable year of the partnership, and the disparity between the book value of the property and the contributing partner's adjusted tax basis in the property is a small disparity, the partnership may --

(A) Use a reasonable section 704(c) method;

(B) Disregard the application of section 704(c) to the property; or

(C) Defer the application of section 704(c) to the property until the disposition of the property.
(ii) Definition of small disparity.

A disparity between book value and adjusted tax basis is a small disparity if the book value of all properties contributed by one partner during the partnership taxable year does not differ from the adjusted tax basis by more than 15 percent of the adjusted tax basis, and the total gross disparity does not exceed $20,000.

(2) Aggregation.

Each of the following types of property may be aggregated for purposes of making allocations under section 704(c) and this section if contributed by one partner during the partnership taxable year.

(i) Depreciable property.

All property, other than real property, that is included in the same general asset account of the contributing partner and the partnership under section 168.

(ii) Zero-basis property.

All property with a basis equal to zero, other than real property.

(iii) Inventory.

For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section).

(3) Special aggregation rule for securities partnerships --

(i) General rule.

For purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of section 704(c). Notwithstanding paragraphs (a)(2) and (a)(6)(i) of this section, once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership. Paragraphs (e)(3)(iv) and (e)(3)(v) of this section describe approaches for aggregating reverse section 704(c) gains and losses that are generally reasonable. Other approaches may be reasonable in appropriate circumstances. See, however, paragraph (a)(10) of this section, which describes the circumstances under which section 704(c) methods, including the aggregate approaches described in this paragraph (e)(3), are not reasonable. A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.

(ii) Qualified financial assets --

(A) In general.
A qualified financial asset is any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in section 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).

(B) Management companies.

For a management company, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

(C) Partnership interests.

An interest in a partnership is not a qualified financial asset for purposes of this paragraph (e)(3)(ii). However, for purposes of this paragraph (e)(3), a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets as follows:

(1) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and

(2) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

(iii) Securities partnership --

(A) In general.

A partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).

(B) Definitions --

(1) Management company.

A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).
(2) Investment partnership.

A partnership is an investment partnership if:

(i) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90 percent of the fair market value of the partnership's non-cash assets; and

(ii) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this paragraph (e)(3), to make revaluations at least annually.

(iv) Partial netting approach.

This paragraph (e)(3)(iv) describes the partial netting approach of making reverse section 704(c) allocations. See Example 1 of paragraph (e)(3)(ix) of this section for an illustration of the partial netting approach. To use the partial netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the partial netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and

(C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

(v) Full netting approach.

This paragraph (e)(3)(v) describes the full netting approach of making reverse section 704(c) allocations on an aggregate basis. See Example 2 of paragraph (e)(3)(ix) of this section for an illustration of the full netting approach. To use the full netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the full netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and
(C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

(vi) Type of tax gain or loss.

The character and other tax attributes of gain or loss allocated to the partners under this paragraph (e)(3) must:

(A) Preserve the tax attributes of each item of gain or loss realized by the partnership;

(B) Be determined under an approach that is consistently applied; and

(C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

(vii) Disqualified securities partnerships.

A securities partnership that adopts an aggregate approach under this paragraph (e)(3) and subsequently fails to qualify as a securities partnership must make reverse section 704(c) allocations on an asset-by-asset basis after the date of disqualification. The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse section 704(c) allocations on or after the date of disqualification.

(viii) Transitional rule for qualified financial assets revalued after effective date.

A securities partnership revaluing its qualified financial assets pursuant to section 1.704-1(b)(2)(iv)(f) on or after the effective date of this section may use any reasonable approach to coordinate with revaluations that occurred prior to the effective date of this section.

(ix) Examples.

The following examples illustrate the principles of this paragraph (e)(3).

Example 1. Operation of the partial netting approach --

(i) Facts.

Two regulated investment companies, X and Y, each contribute $150,000 in cash to form PRS, a partnership that registers as a management company. The partnership agreement provides that book items will be allocated in accordance with the partners' relative book capital accounts, that book capital accounts will be adjusted to reflect daily revaluations of property pursuant to section 1.704-1(b)(2)(iv)(f)(5)(iii), and that reverse section 704(c) allocations will be made using the partial netting approach described in paragraph (e)(3)(iv) of this section. X and Y each have an initial book capital account of $150,000. In addition, the partnership establishes for each of X and Y a revaluation account with a beginning balance of $0. On Day 1, PRS buys Stock 1, Stock 2, and Stock 3 for $100,000 each. On Day 2, Stock 1 increases in value from $100,000 to $102,000, Stock 2 increases in value from $100,000 to $105,000, and Stock 3 declines in value from $100,000 to
$98,000. At the end of Day 2, Z, a regulated investment company, joins PRS by contributing $152,500 in cash for a one-third interest in the partnership [$152,500 divided by $300,000 (initial values of stock) + $5,000 (net gain at end of Day 2) + $152,500]. PRS uses this cash to purchase Stock 4. PRS establishes a revaluation account for Z with a $0 beginning balance. As of the close of Day 3, Stock 1 increases in value from $102,000 to $105,000, and Stocks 2, 3, and 4 decrease in value from $105,000 to $102,000, from $98,000 to $96,000, and from $152,500 to $151,500, respectively. At the end of Day 3, PRS sells Stocks 2 and 3.

(ii) Book allocations --

Day 2. At the end of Day 2, PRS revalues the partnership's qualified financial assets and increases X's and Y's book capital accounts by each partner's 50 percent share of the $5,000 ($2,000 + $5,000 - $2,000) net increase in the value of the partnership's assets during Day 2. PRS increases X's and Y's respective revaluation account balances by $2,500 each to reflect the amount by which each partner's book capital account increased on Day 2. Z's capital account is not affected because Z did not join PRS until the end of Day 2. At the beginning of Day 3, the partnership's accounts are as follows:

<table>
<thead>
<tr>
<th>Stock 1</th>
<th>Stock 2</th>
<th>Stock 3</th>
<th>Stock 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>-</td>
</tr>
<tr>
<td>2,000</td>
<td>5,000</td>
<td>(2,000)</td>
<td>-</td>
</tr>
<tr>
<td><strong>$102,000</strong></td>
<td><strong>$105,000</strong></td>
<td><strong>$98,000</strong></td>
<td><strong>$152,500</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Tax</th>
<th>Revaluation Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$150,000</td>
<td>$150,000</td>
<td>$0</td>
</tr>
<tr>
<td>$2,500</td>
<td>0</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td><strong>$152,500</strong></td>
<td><strong>$150,000</strong></td>
<td><strong>$2,500</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Y</th>
<th>Tax</th>
<th>Revaluation Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$150,000</td>
<td>$150,000</td>
<td>$0</td>
</tr>
<tr>
<td>$2,500</td>
<td>0</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td><strong>$152,500</strong></td>
<td><strong>$150,000</strong></td>
<td><strong>$2,500</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Z</th>
<th>Tax</th>
<th>Revaluation Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>$152,500</strong></td>
<td><strong>$152,500</strong></td>
<td><strong>$0</strong></td>
<td></td>
</tr>
</tbody>
</table>

(iii) Book and tax allocations --

Day 3. At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the $3,000 ($3,000 -
$3,000 - $2,000 - $1,000) net decrease in the value of the partnership's qualified financial assets. PRS also reduces each partner's revaluation account balance by $1,000. Accordingly, X's and Y's revaluation account balances are reduced to $1,500 each and Z's revaluation account balance is ($1,000). PRS then separately allocates the tax gain from the sale of Stock 2 and the tax loss from the sale of Stock 3. The $2,000 of tax gain recognized on the sale of Stock 2 ($102,000 - $100,000) is allocated among the partners with positive revaluation account balances in accordance with the relative balances of those revaluation accounts. X's and Y's revaluation accounts have equal positive balances; thus, PRS allocates $1,000 of the gain from the sale of Stock 2 to X and $1,000 of that gain to Y. PRS allocates none of the gain from the sale to Z because Z's revaluation account balance is negative. The $4,000 of tax loss recognized from the sale of Stock 3 ($96,000 - $100,000) is allocated first to the partners with negative revaluation account balances to the extent of those balances. Because Z is the only partner with a negative revaluation account balance, the tax loss is allocated first to Z to the extent of Z's ($1,000) balance. The remaining $3,000 of tax loss is allocated among the partners in accordance with their distributive shares of the loss. Accordingly, PRS allocates $1,000 of tax loss from the sale of Stock 3 to each of X and Y. PRS also allocates an additional $1,000 of the tax loss to Z, so that Z's total share of the tax loss from the sale of Stock 3 is $2,000. PRS then reduces each partner's revaluation account balance by the amount of any tax gain allocated to that partner and increases each partner's revaluation account balance by the amount of any tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

<table>
<thead>
<tr>
<th>Stock 1</th>
<th>Stock 2</th>
<th>Stock 3</th>
<th>Stock 4</th>
<th>Opening balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$152,500</td>
<td></td>
</tr>
<tr>
<td>2,000</td>
<td>5,000</td>
<td>(2,000)</td>
<td>-</td>
<td>Day 2 adjustment</td>
</tr>
<tr>
<td>3,000</td>
<td>(3,000)</td>
<td>(2,000)</td>
<td>(1,000)</td>
<td>Day 3 adjustment</td>
</tr>
<tr>
<td>$105,000</td>
<td>$102,000</td>
<td>$96,000</td>
<td>$151,500</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>X and Y</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>Tax</td>
<td>Revaluation Account</td>
<td></td>
</tr>
<tr>
<td>$150,000</td>
<td>$150,000</td>
<td>$0</td>
<td>Opening balance</td>
</tr>
<tr>
<td>2,500</td>
<td>0</td>
<td>2,500</td>
<td>Day 2 adjustment</td>
</tr>
<tr>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
<td>Day 3 adjustment</td>
</tr>
<tr>
<td>$151,500</td>
<td>$150,000</td>
<td>$1,500</td>
<td>Total</td>
</tr>
<tr>
<td>0</td>
<td>1,000</td>
<td>(1,000)</td>
<td>Gain from Stock 2</td>
</tr>
<tr>
<td>0</td>
<td>(1,000)</td>
<td>1,000</td>
<td>Gain from Stock 3</td>
</tr>
<tr>
<td>$151,500</td>
<td>$150,000</td>
<td>$1,500</td>
<td>Closing balance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Z</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>Tax</td>
<td>Revaluation Account</td>
<td></td>
</tr>
<tr>
<td>$152,500</td>
<td>$152,500</td>
<td>$0</td>
<td>Opening balance</td>
</tr>
<tr>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
<td>Day 3 adjustment</td>
</tr>
<tr>
<td>$151,500</td>
<td>$152,500</td>
<td>($1,000)</td>
<td>Total</td>
</tr>
</tbody>
</table>
Example 2. Operation of the full netting approach --

(i) Facts.

The facts are the same as in Example 1, except that the partnership agreement provides that PRS will make reverse section 704(c) allocations using the full netting approach described in paragraph (e)(3)(v) of this section.

(ii) Book allocations --

Days 2 and 3. PRS allocates its book gains and losses in the manner described in paragraphs (ii) and (iii) of Example 1 (the partial netting approach). Thus, at the end of Day 2, PRS increases the book capital accounts of X and Y by $2,500 to reflect the appreciation in the partnership's assets from the close of Day 1 to the close of Day 2 and records that increase in the revaluation account created for each partner. At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the decline in value of the partnership's assets from Day 2 to Day 3 and reduces each partner's revaluation account by a corresponding amount.

(iii) Tax allocations --

Day 3. After making the book adjustments described in the previous paragraph, PRS allocates its net tax gain (or net tax loss) from its sales of qualified financial assets during Day 3. To do so, PRS first determines its net tax gain (or net tax loss) recognized from its sales of qualified financial assets for the day. There is a $2,000 net tax loss ($2,000 gain from the sale of Stock 2 less $4,000 loss from the sale of Stock 3) on the sale of PRS's qualified financial assets. Because Z is the only partner with a negative revaluation account balance, the partnership's net tax loss is allocated first to Z to the extent of Z's ($1,000) revaluation account balance. The remaining net tax loss is allocated among the partners in accordance with their distributive shares of loss. Thus, PRS allocates $333.33 of the $2,000 net tax loss to each of X and Y. PRS also allocates an additional $333.33 of the net tax loss to Z, so that the total net tax loss allocation to Z is $1,333.33. PRS then increases each partner's revaluation account balance by the amount of net tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

<table>
<thead>
<tr>
<th>Stock 1</th>
<th>Stock 2</th>
<th>Stock 3</th>
<th>Stock 4</th>
<th>Stock 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$152,500</td>
<td></td>
</tr>
<tr>
<td>2,000</td>
<td>5,000</td>
<td>(2,000)</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3,000</td>
<td>(3,000)</td>
<td>(2,000)</td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td>$105,000</td>
<td>$102,000</td>
<td>$96,000</td>
<td>$151,500</td>
<td></td>
</tr>
</tbody>
</table>

X and Y
<table>
<thead>
<tr>
<th>Book</th>
<th>Tax</th>
<th>Revaluation Account</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$150,000</td>
<td>$150,500</td>
<td>$0</td>
<td>Opening balance</td>
</tr>
<tr>
<td>2,500</td>
<td>0</td>
<td>2,500</td>
<td>Day 2 adjustment</td>
</tr>
<tr>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
<td>Day 3 adjustment</td>
</tr>
<tr>
<td>$151,500</td>
<td>$150,500</td>
<td>$1,500</td>
<td>Total</td>
</tr>
<tr>
<td>0</td>
<td>(333)</td>
<td>333</td>
<td>Net tax loss – Stocks 2 and 3</td>
</tr>
<tr>
<td>$151,500</td>
<td>$149,667</td>
<td>$1,833</td>
<td>Closing balance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Z</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$152,500</td>
<td>$152,500</td>
<td>$0</td>
<td>Opening balance</td>
</tr>
<tr>
<td>(1,000)</td>
<td>0</td>
<td>(1,000)</td>
<td>Day 3 adjustment</td>
</tr>
<tr>
<td>$151,500</td>
<td>$152,500</td>
<td>($1,000)</td>
<td>Total</td>
</tr>
<tr>
<td>0</td>
<td>(1,333)</td>
<td>1,333</td>
<td>Net tax loss – Stocks 2 and 3</td>
</tr>
<tr>
<td>$151,500</td>
<td>$151,167</td>
<td>$333</td>
<td>Closing balance</td>
</tr>
</tbody>
</table>

(4) Aggregation as permitted by the commissioner.

The Commissioner may, by published guidance or by letter ruling, permit:

(i) Aggregation of properties other than those described in paragraphs (e)(2) and (e)(3) of this section;

(ii) Partnerships and partners not described in paragraph (e)(3) of this section to aggregate gain and loss from qualified financial assets; and

(iii) Aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described in paragraph (e)(3) of this section.

(f) Effective date.

With the exception of paragraph (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to section 1.704-1(b)(2)(iv)(f) on or after December 21, 1993. Paragraph (a)(11) of this section applies to properties contributed by a partner to a partnership on or after August 20, 1997. However, partnerships may rely on paragraph (a)(11) of this section for properties contributed before August 20, 1997, and disposed of on or after August 20, 1997.


Sec. 1.704-3T Contributed property (Temporary).
Sec. 1.704-4 Distribution of contributed property.

(a) DETERMINATION OF GAIN AND LOSS --

(1) IN GENERAL.

A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and section 1.704-3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See section 1.704-3(a)(3)(i) for a definition of section 704(c) property.

(2) TRANSACTIONS TO WHICH SECTION 704(c)(1)(B) APPLIES.

Section 704(c)(1)(B) and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731.

(3) FAIR MARKET VALUE OF PROPERTY.

The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) DETERMINATION OF FIVE-YEAR PERIOD --

(i) GENERAL RULE.

The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) SECTION 708(b)(1)(B) TERMINATIONS.

A termination of the partnership under section 708(b)(1)(B) does not begin a new five-year period for each partner with respect to the built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under section 1.708-1(b)(1)(iv). See section 1.704-3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property. This paragraph (a)(4)(ii) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a)(4)(ii) may be applied to terminations occurring
on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a)(4)(ii) to the termination in a consistent manner.

(5) EXAMPLES.

The following examples illustrate the rules of this paragraph (a). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

EXAMPLE 1. RECOGNITION OF GAIN.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. Thus, there is a built-in gain of $6,000 on Property A at the time of contribution. B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C’s interest in the partnership.

(iii) A would have recognized $6,000 of gain under section 704(c)(1)(A) and section 1.704-3 on the sale of Property A at the time of the distribution ($10,000 fair market value less $4,000 adjusted tax basis). As a result, A must recognize $6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and section 1.704-3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

EXAMPLE 2. EFFECT OF POST-CONTRIBUTION DEPRECIATION DEDUCTIONS.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of $30,000 and an adjusted tax basis of $20,000. Therefore, there is a built-in gain of $10,000 on Property A. B and C each contribute $30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in section 1.704-3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis), and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership has a tax depreciation deduction of $2,000 per year (10 percent of the $20,000 tax basis in Property A). This $2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.
(iii) At the end of the third year, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and the adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is $7,000 ($21,000 book value less $14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under section 704(c)(1)(A) and section 1.704-3(b). Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.

EXAMPLE 3. EFFECT OF REMEDIAL METHOD.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. B and C each contribute $20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in section 1.704-3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased to $7,000, Property A1 is distributed to C in a current distribution. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the $2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of $7,000 less $5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of $3,000 ($10,000 original book value less $7,000 current fair market value of the property). Book loss in the amount of $2,000 would have been allocated equally between B and C. Under the remedial method, $2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, $2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized $4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 ($2,000 of section 704(c) recognized gain plus $2,000 remedial gain). Therefore, A recognizes $4,000 of gain on the distribution of Property A1 to C under this section.

(b) CHARACTER OF GAIN OR LOSS --

(1) GENERAL RULE.

Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) EXAMPLE.

The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the
partnership, the fair market value of partnership property does not change, all
distributions by the partnership are subject to section 704(c)(1)(B), and all
partners are unrelated.

EXAMPLE. CHARACTER OF GAIN.

(i) On January 1, 1995, A and B form partnership AB. A contributes $10,000 and
Property A, nondepreciable real property with a fair market value of $10,000 and
an adjusted tax basis of $4,000, in exchange for a 25 percent interest in
partnership capital and profits. B contributes $60,000 cash for a 75 percent
interest in partnership capital and profits.

Property A is used in a trade or business of B.

(iii) A would have recognized $6,000 of gain under section 704(c)(1)(A) on a sale
of Property A at the time of the distribution (the difference between the fair
market value ($10,000) and the adjusted tax basis ($4,000) of the property at
that time). Because Property A is not a capital asset in the hands of Partner B
and B holds more than 50 percent of partnership capital and profits, the
character of the gain on a sale of Property A to B would have been ordinary
income under section 707(b)(2). Therefore, the character of the gain to A on the
distribution of Property A to B is ordinary income.

(c) EXCEPTIONS --

(1) PROPERTY CONTRIBUTED ON OR BEFORE OCTOBER 3, 1989.

Section 704(c)(1)(B) and this section do not apply to property contributed to
the partnership on or before October 3, 1989.

(2) CERTAIN LIQUIDATIONS.

Section 704(c)(1)(B) and this section do not apply to a distribution of an
interest in section 704(c) property to a partner other than the contributing partner
in a liquidation of the partnership if--

(i) The contributing partner receives an interest in the section 704(c)
property contributed by that partner (and no other property);

(ii) The built-in gain or loss in the interest distributed to the contributing
partner, determined immediately after the distribution, is equal to or greater
than the built-in gain or loss on the property that would have been allocated
to the contributing partner under section 704(c)(1)(A) and section 1.704-3 on
a sale of the contributed property to an unrelated party immediately before
the distribution.

(3) SECTION 708(b)(1)(B) TERMINATION.

Section 704(c)(1)(B) and this section do not apply to the deemed distribution
of interests in a new partnership caused by the termination of a partnership
under section 708(b)(1)(B). A subsequent distribution of section 704(c) property
by the new partnership to a partner of the new partnership is subject to section
704(c)(1)(B) to the same extent that a distribution by the terminated partnership
would have been subject to section 704(c)(1)(B). See also section 1.737-2(a) for a similar rule in the context of section 737. This paragraph (c)(3) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (c)(3) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (c)(3) to the termination in a consistent manner.

(4) COMPLETE TRANSFER TO ANOTHER PARTNERSHIP.

Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See section 1.737-2(b) for a similar rule in the context of section 737.

(5) INCORPORATION OF A PARTNERSHIP.

Section 704(c)(1)(B) and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See section 1.737-2(c) for a similar rule in the context of section 737.

(6) UNDIVIDED INTERESTS.

Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See section 1.737-2(d)(4) for the application of section 737 in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(7) EXAMPLE.

The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

**EXAMPLE.** (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of $20,000. B contributes Property B, nondepreciable real property with a fair market value of $20,000 and an adjusted
tax basis of $10,000. Property B therefore has a built-in gain of $10,000 at the
time of contribution.

(ii) On December 31, 1998, the partnership liquidates when the fair market value
of Property A has not changed, but the fair market value of Property B has
increased to $40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property
B. This interest in Property B has a fair market value of $10,000 to A, reflecting
the fact that A was entitled to 50 percent of the $20,000 post-contribution
appreciation in Property B. The partnership distributes to B a 75 percent interest
in Property B with a fair market value of $30,000. B’s basis in this portion of
Property B is $10,000 under section 732(b). As a result, B has a built-in gain of
$20,000 in this portion of Property B immediately after the distribution ($30,000
fair market value less $10,000 adjusted tax basis). This built-in gain is greater
than the $10,000 of built-in gain in Property B at the time of contribution to the
partnership. B therefore does not recognize any gain on the distribution of a
portion of Property B to A under this section.

(d) SPECIAL RULES --

(1) NONRECOGNITION TRANSACTIONS.

Property received by the partnership in exchange for section 704(c) property
in a nonrecognition transaction is treated as the section 704(c) property for
purposes of section 704(c)(1)(B) and this section to the extent that the property
received is treated as section 704(c) property under section 1.704-3(a)(8). See
section 1.737-2(d)(3) for a similar rule in the context of section 737.

(2) TRANSFERS OF A PARTNERSHIP INTEREST.

The transferee of all or a portion of the partnership interest of a contributing
partner is treated as the contributing partner for purposes of section 704(c)(1)(B)
and this section to the extent of the share of built-in gain or loss allocated to the
transferee partner. See section 1.704-3(a)(7).

(3) DISTRIBUTIONS OF LIKE-KIND PROPERTY.

If section 704(c) property is distributed to a partner other than the
contributing partner and like-kind property (within the meaning of section 1031) is
distributed to the contributing partner no later than the earlier of (i) 180 days
following the date of the distribution to the non-contributing partner, or (ii) the
due date (determined with regard to extensions) of the contributing partner’s
income tax return for the taxable year of the distribution to the noncontributing
partner, the amount of gain or loss, if any, that the contributing partner would
otherwise have recognized under section 704(c)(1)(B) and this section is
reduced by the amount of built-in gain or loss in the distributed like-kind property
in the hands of the contributing partner immediately after the distribution. The
contributing partner’s basis in the distributed like-kind property is determined as if
the like-kind property were distributed in an unrelated distribution prior to the
distribution of any other property distributed as part of the same distribution and
is determined without regard to the increase in the contributing partner’s adjusted
tax basis in the partnership interest under section 704(c)(1)(B) and this section. See section 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

(4) EXAMPLE.

The following example illustrates the rules of this paragraph (d). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

EXAMPLE. DISTRIBUTION OF LIKE-KIND PROPERTY.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $20,000 and an adjusted tax basis of $10,000. B and C each contribute $20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of $8,000. The fair market value of Property X subsequently increases to $10,000.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under section 1.707-3. A's basis in Property X is $8,000 under section 732(a)(1). A therefore has $2,000 of built-in gain in Property X ($10,000 fair market value less $8,000 adjusted tax basis).

(iii) A would generally recognize $10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value ($20,000) of the property and its adjusted tax basis ($10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only $8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) BASIS ADJUSTMENTS --

(1) CONTRIBUTING PARTNER'S BASIS IN THE PARTNERSHIP INTEREST.

The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property, other than like-kind property described in paragraph (d)(3) of this section (pertaining to the special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner.
under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see section 1.737-3(a).

(2) PARTNERSHIP'S BASIS IN PARTNERSHIP PROPERTY.

The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see section 1.737-3(b).

(3) SECTION 754 ADJUSTMENTS.

The basis adjustments to partnership property made pursuant to paragraph (e)(2) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See section 1.737-3(c)(4) for a similar rule in the context of section 737.

(4) EXAMPLE.

The following example illustrates the rules of this paragraph (e). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

EXAMPLE. BASIS ADJUSTMENT.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C each contribute $20,000 cash.


(iii) Under paragraph (a) of this section, A recognizes $6,000 of gain on the distribution of Property A because that is the amount of gain that would have been allocated to A under section 704(c)(1)(A) and section 1.704-3 on a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A ($10,000) less its adjusted tax basis at the time of distribution ($4,000)). The adjusted tax basis of A's partnership interest is increased from $14,000 to $20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from $4,000 to $10,000
immediately prior to its distribution to B. B’s adjusted tax basis in Property A is therefore $10,000 under section 732(a)(1).

(f) ANTI-ABUSE RULE --

(1) IN GENERAL.

The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See section 1.737-4 for an anti-abuse rule and examples in the context of section 737.

(2) EXAMPLES.

The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

EXAMPLE 1. DISTRIBUTION IN SUBSTANCE MADE WITHIN FIVE-YEAR PERIOD; RESULTS INCONSISTENT WITH THE PURPOSE OF SECTION 704(c)(1)(B).

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B and C each contributes $10,000 cash.

(ii) On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B’s interest in the partnership. If Property A were distributed at that time, however, A would recognize $9,000 of gain under section 704(c)(1)(B), the difference between the $10,000 fair market value and the $1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five years before December 31, 1998. On becoming aware of this potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A
until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The actual distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this Example 1 that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of $9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

EXAMPLE 2. SUSPENSION OF FIVE-YEAR PERIOD IN MANNER CONSISTENT WITH THE PURPOSE OF SECTION 704(c)(1)(B).

(i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes $10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquiror of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for $10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.
(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquiror of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this Example 2 would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of $9,000 under section 704(c)(1)(B) on the distribution.

(g) EFFECTIVE DATE.

This section applies to distributions by a partnership to a partner on or after January 9, 1995.


Sec. 7.704-1 Partner's distributive share.

(a)--(c) [Reserved]

(d) Limitation on allowance of losses.

(1)--(2) [Reserved]

(3)(i) Section 213(e) of the Tax Reform Act of 1976 amended section 704(d) of the Internal Revenue Code relating to the deductions by partners of losses incurred by a partnership. A partner is entitled to deduct the share of partnership loss to the extent of the adjusted basis of the partner's interest in the partnership. As amended, section 704(d) provides, in general, that the adjusted basis of a partner's interest in the partnership for the purpose of deducting partnership losses shall not include any portion of a partnership liability for which the partner has no personal liability. This restriction, however, does not apply to any activity to the extent that section 465 of the Code applies nor to any partnership whose principal activity is investing in real property, other than mineral property. Section
465 does not apply to corporations other than a subchapter S corporation or a personal holding company.

(ii) The restrictions in the amendment to section 704(d) will not apply to any corporate partner with respect to liabilities incurred in an activity described in section 465(c)(1). In all other respects the restrictions in the amendment will apply to all corporate partners unless the partnership’s principal activity is investment in real property, other than mineral property.


Sec. 1.705-1 Determination of basis of partner’s interest.

(a) General rule.

(1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", "equity", or similar account. For example, A contributes property with an adjusted basis to him of $400 (and a value of $1,000) to a partnership. B contributes $1,000 cash. While under their agreement each may have a "capital account" in the partnership of $1,000, the adjusted basis of A's interest is only $400 and B's interest $1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property, unless the property is an oil or gas property the basis of which has been allocated to partners under section 613A(c)(7)(D).
(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner’s distributive share for the taxable year and prior taxable years of:

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) The basis shall be decreased (but not below zero) by the amount of the partner’s deduction for depletion allowable under section 611 for any partnership oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the partner under section 613A(c)(7)(D).

(5) The basis shall be adjusted (but not below zero) to reflect any gain or loss to the partner resulting from a disposition by the partnership of a domestic oil or gas property after December 31, 1974.

(6) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and section 1.752-1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of Subchapter K, Chapter 1 of the Code, or any of the sections thereof, the partner’s share of partnership liabilities on that date shall be included.

(b) Alternative rule.

In certain cases, the adjusted basis of a partner’s interest in a partnership may be determined by reference to the partner’s share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner’s interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner’s interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner’s share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example (1). The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner’s share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner’s adjusted basis for his partnership interest.
Example (2). Assume that partner A in example (1) of this paragraph sells his partnership interest to D for $1,250 at a time when the partnership property with an adjusted basis of $1,500 had appreciated in value to $3,000, and when the partnership also had $750 in cash. The total adjusted basis of all partnership property is $2,250 and the value of such property is $3,750. D's basis for his partnership interest is his cost, $1,250. However, his one-third share of the adjusted basis of partnership property is only $750. Therefore, for the purposes of the alternative rule, D has an adjustment of $500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional $1,500, its property will have an adjusted basis of $3,750. D's adjusted basis for his interest under the alternative rule is $1,750, determined by adding $500, his basis adjustment to $1,250 (his one-third share of the $3,750 adjusted basis of partnership property). If the partnership distributes $250 to each partner in a current distribution, D's adjusted basis for his interest will be $1,500 ($1,000, his one-third share of the remaining basis of partnership property, $3,000, plus his basis adjustment of $500).

Example (3). Assume that BCD partnership in example (2) of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Depreciable property</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Land held for investment</td>
<td>18,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Total</td>
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<td>42,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>Per books</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital accounts</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>4,500</td>
</tr>
<tr>
<td>C</td>
<td>4,500</td>
</tr>
<tr>
<td>D</td>
<td>15,000</td>
</tr>
<tr>
<td>Total</td>
<td>30,000</td>
</tr>
</tbody>
</table>

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase of his interest. See example (2) of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property
(reduced by the amount of liabilities) at time of proposed sale $15,000

D's share of partnership liabilities (under the partnership agreement liabilities are shared equally) 2,000

D's basis adjustment from example (2) 500

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Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule 17,500

[T.D. 8437, 57 FR 43897-43904, Sept. 23, 1992.]

**Sec. 1.706-1 Taxable years of partner and partnership.**

(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, D.C. 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 section 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 section 1.442-2T and section 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 section 1.442-2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see section 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 section 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 section 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 includable 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 distributives 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 section 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 taxable 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).


Sec. 1.706-1T Taxable years of certain partnership (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 section 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.

(3) Determination of the taxable year of a partner or partnership that uses a 52-53 week taxable year.

For purposes of the calculation described in paragraph (a)(2) of this section, the taxable year of a partner or partnership that uses a 52-53 week taxable year shall be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(4) Special de minimis rule.
If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the partnership's current taxable year shall be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year. However, this de minimis rule will not apply to the first taxable period beginning after December 31, 1986.

(b) Business purpose.

A partnership may have a taxable year other than the year described in paragraph (a) of this section if it establishes, to the satisfaction of the Commissioner of Internal Revenue, a business purpose for such taxable year in accordance with and under the procedures established in section 1.442-1(b)(1). For purposes of this paragraph (b), any deferral of income to partners shall not be treated as a business purpose.

(c) Procedural requirements and effective date--

(1) In general.

The change in accounting period required by paragraph (a) of this section shall be treated as initiated by the partnership and made with the consent of the Commissioner. To effect the change, a partnership must show that the requirements of this section are satisfied in a statement setting forth the computations required to establish the taxable year that results in the least aggregate deferral of income to the partners under paragraph (a) of this section. The partnership must attach the statement to the income tax return for the short period involved in the changes and must indicate the following at the top of page 1 of the return: "FILED UNDER section 1.706-1T."

(2) Effective date--

(i) In general.

Except as provided in paragraph (c)(2)(ii) of this section, the rules of this section are effective for partnership taxable years beginning after December 31, 1986.

(ii) Special rule for first taxable year beginning after December 31, 1986.

A partnership otherwise required to change its accounting period for its first taxable year beginning after December 31, 1986 to a year resulting in the least aggregate deferral of income to its partners under paragraph (a) of this section, may, at its option, delay the application of the rules of that paragraph until its first taxable year beginning after December 31, 1987. In such a case, the partnership must conform its first taxable year beginning after December 31, 1986 to the calendar year and must apply the rules of paragraph (a) of this section to its first taxable year beginning after December 31, 1987. See section 1.702-3T(a)(1) regarding the availability of a 4-year spread provision with respect to a partnership required to change its taxable year for its first taxable year beginning after December 31, 1986.
(iii) Special eligibility for 4-year spread; years beginning after December 31, 1987.

Notwithstanding the provisions of section 1.702-3T(a)(1) limiting the availability of the 4-year spread provisions to a partnership's first taxable year beginning after December 31, 1986, if--

(A) A partnership is required under section 706(b)(1)(B)(iii) and paragraph (a) of this section to change to a taxable year that results in the least aggregate deferral of income to the partners for a partnership's first taxable year beginning after December 31, 1987,

(B) The partnership did exercise its option, as provided in paragraph (c)(2)ii) of this section, to delay the application of the rules of paragraph (a) of this section until the partnership's first taxable year beginning after December 31, 1987, and

(C) The partnership would have been required to change its accounting period under section 706(b)(1)(B)(iii) and paragraph (a) of this section for its first taxable year beginning after December 31, 1986, if paragraph (a) of this section had been applicable to such taxable year, the partners in the partnership will be eligible to utilize the 4-year spread provision provided in section 1.702-3T (subject to the other requirements of that section) with respect to the partnership's change in accounting period required under section 706(b)(1)(B)(iii) and paragraph (a) of this section for the partnership's first taxable year beginning after December 31, 1987.

(d) Examples.

The principles of this section may be illustrated by the following examples:

**Example (1).** Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

<table>
<thead>
<tr>
<th>Test 6/30 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 6/30 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 6/30</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner B 7/31</td>
<td>.5</td>
<td>1</td>
<td>.5</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
<td></td>
<td>.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test 7/31 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 7/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 6/30</td>
<td>.5</td>
<td>11</td>
<td>5.5</td>
</tr>
</tbody>
</table>
Example (2). The facts are the same as in Example (1) except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

<table>
<thead>
<tr>
<th>Test</th>
<th>Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 12/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>12/31</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner B</td>
<td>11/30</td>
<td>.5</td>
<td>11</td>
<td>5.5</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
<td></td>
<td></td>
<td>5.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test</th>
<th>Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 11/30 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>12/31</td>
<td>.5</td>
<td>1</td>
<td>.5</td>
</tr>
<tr>
<td>Partner B</td>
<td>11/30</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Aggregate deferral</td>
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<td></td>
<td></td>
<td>.5</td>
</tr>
</tbody>
</table>

Example (3). The facts are the same as in Example (2) except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year.

<table>
<thead>
<tr>
<th>Test</th>
<th>Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 12/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>12/31</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner B</td>
<td>6/30</td>
<td>.5</td>
<td>6</td>
<td>3.0</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
<td></td>
<td></td>
<td>3.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test</th>
<th>Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 6/30 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>12/31</td>
<td>.5</td>
<td>6</td>
<td>3.0</td>
</tr>
<tr>
<td>Partner B</td>
<td>6/30</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Aggregate deferral</td>
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<td></td>
<td></td>
<td>3.0</td>
</tr>
</tbody>
</table>

Example (4). The facts are the same as in Example (1) except that on December
31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

**Example (5).** The facts are the same as in Example (4) except that Partner D reports income on the fiscal year ending April 30. As in Example (4), the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

<table>
<thead>
<tr>
<th>Test 7/31 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 7/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 6/30</td>
<td>.06</td>
<td>11</td>
<td>0.66</td>
</tr>
<tr>
<td>Partner B 7/31</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner C 6/30</td>
<td>.04</td>
<td>11</td>
<td>0.44</td>
</tr>
<tr>
<td>Partner D 4/30</td>
<td>.4</td>
<td>9</td>
<td>3.60</td>
</tr>
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<td>4.70</td>
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<table>
<thead>
<tr>
<th>Test 6/30 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 6/30 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 6/30</td>
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<td>0</td>
</tr>
<tr>
<td>Partner B 7/31</td>
<td>.5</td>
<td>1</td>
<td>0.5</td>
</tr>
<tr>
<td>Partner C 6/30</td>
<td>.04</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner D 4/30</td>
<td>.4</td>
<td>10</td>
<td>4.0</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
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<table>
<thead>
<tr>
<th>Test 4/30 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 4/30 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 6/30</td>
<td>.06</td>
<td>2</td>
<td>0.12</td>
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<tr>
<td>Partner B 7/31</td>
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<td>1.50</td>
</tr>
<tr>
<td>Partner C 6/30</td>
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<td>2</td>
<td>0.08</td>
</tr>
<tr>
<td>Partner D 4/30</td>
<td>.4</td>
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<td>0</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
<td></td>
<td>1.70</td>
</tr>
</tbody>
</table>

**Section 1.706-1T(a)(4) Test:**

Current taxable year (June 30) 4.5
Less: Taxable year producing the
Example (6). Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under section 1.706-1T(a)(2) to be the fiscal year ending March 31 as follows:

<table>
<thead>
<tr>
<th>Test 6/30 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 7/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 3/31</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner B 7/31</td>
<td>.5</td>
<td>4</td>
<td>2</td>
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<tr>
<td>Aggregate deferral</td>
<td></td>
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<td>2</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Test 7/31 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 7/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 3/31</td>
<td>.5</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Partner B 7/31</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner C 4/30</td>
<td>.45</td>
<td>1</td>
<td>0.45</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
<td></td>
<td>4</td>
</tr>
</tbody>
</table>

In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (a)(4) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

<table>
<thead>
<tr>
<th>Test 3/31 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 3/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
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<tbody>
<tr>
<td>Partner A 3/31</td>
<td>.05</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partner B 7/31</td>
<td>.5</td>
<td>4</td>
<td>2</td>
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<tr>
<td>Partner C 4/30</td>
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<th>Test 7/31 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 7/31 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A 3/31</td>
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<td>0.40</td>
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<tr>
<td>Partner B 7/31</td>
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<td>0</td>
</tr>
<tr>
<td>Partner C 4/30</td>
<td>.45</td>
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<td>4.05</td>
</tr>
<tr>
<td>Aggregate deferral</td>
<td></td>
<td></td>
<td>4.45</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Test 4/30 Year End</th>
<th>Interest in Partnership Profits</th>
<th>Months of Deferral for 4/30 Year End</th>
<th>Interest x Deferral</th>
</tr>
</thead>
</table>
Partner A 3/31 .05 11 0.55
Partner B 7/31 .5 3 1.50
Partner C 4/30 .45 0 0
Aggregate deferral

Section 1.706-1T(a)(4) Test:
Current taxable year (3/31) 2.45
Less: Taxable year producing the
least aggregate deferral (4/30) 2.05
Additional aggregate deferral (less than .5) 0.40

T.D. 8205, 53 FR 19711, May 27, 1988]

Sec. 1.706-2T Temporary regulations; question and answer
under the Tax Reform Act of 1984.

Question 1: For purposes of section 706(d), how is an otherwise deductible amount that
is deferred under section 267(a)(2) treated?

Answer 1: In the year the deduction is allowed, the deduction will constitute an allocable
cash basis item under section 706(d)(2)(B)(iv).

1502; 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7991, 49 FR 47001, Nov. 30, 1984]

Sec. 1.706-3T Temporary regulations under the Tax Reform Act

(a) Certain tax-exempt partners disregarded--

(1) General rule.

In determining the taxable year (the "current year") of a partnership under
section 706(b) and the regulations thereunder, a partner that is tax-exempt under
section 501(a) shall be disregarded if such partner was not subject to tax, under
chapter 1 of the Code, on any income attributable to its investment in the
partnership during the partnership's taxable year immediately preceding the
current year. However, if a partner that is tax-exempt under section 501(a) was
not a partner during the partnership's immediately preceding taxable year, such
partner will be disregarded for the current year if the partnership reasonably
believes that the partner will not be subject to tax, under chapter 1 of the Code,
on any income attributable to such partner's investment in the partnership during
the current year.
Example. Assume that partnership A has historically used the calendar year as its taxable year. In addition, assume that A is owned by 5 partners, 4 calendar year individuals (each owning 10 percent of A’s profits and capital) and a tax-exempt organization (owning 60 percent of A’s profits and capital). The tax-exempt organization has never had unrelated business taxable income with respect to A and has historically used a June 30 fiscal year. Finally, assume that A desires to retain the calendar year for its taxable year beginning January 1, 1987. Under these facts and but for the special rule in paragraph (a)(1) of this section, A would be required under section 706(b)(1)(B)(i) to change to a year ending June 30, for its taxable year beginning January 1, 1987. However, under the special rule provided in paragraph (a)(1) of this section, and assuming the optional effective date provided in paragraph (c) of this section is chosen, the partner that is tax-exempt is disregarded, and A must retain the calendar year, under section 706(b)(1)(B)(i), for its taxable year beginning January 1, 1987.

(b) Effect of partner elections under section 444.

For purposes of section 706(b)(1)(B), any section 444 election by a partner in a partnership shall be taken into account in determining the taxable year of the partnership. See example (4) of section 1.7519-1T(d).

(c) Effective date.

The provisions of this section are generally effective for taxable years beginning after December 31, 1987. However, a partnership may, at its option, apply the provisions of this section for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19710, May 27, 1988]

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Sec. 1.707-1 Transactions between partner and partnership.
   (a) Partner not acting in capacity as partner.


A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph(c)(3) of section 1.731-1.

(b) Certain sales or exchanges of property with respect to controlled partnerships

(1) Losses disallowed.

   (i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership), directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership shall not be allowed.

   (ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267(d) (relating to amount of gain where loss previously disallowed) shall apply as though the loss were disallowed under section 267(a)(1).

(2) Gains treated as ordinary income.

Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interest or profits interest in each partnership. The term "property other than a capital asset" includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) Ownership of a capital or profits interest.
In determining the extent of the ownership by a partner, as defined in section 761(b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267(c) (1), (2), (4), and (5) shall be applied for the purpose of section 707(b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner of such interest under section 267(c). However, section 707(b)(1)(A) does not apply to a constructive owner of a partnership interest since he is not a partner as defined in section 761(b). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW only for the purpose of further attributing the ownership of such interest to A. See section 267(c) (1) and (5). If A, B, and T are equal partners, then A will be considered as owning more than 50 percent of the capital and profits interest in the partnership, and losses on transactions between him and the partnership will be disallowed by section 707(b)(1)(A). However, a loss sustained by AW on a sale or exchange of property with the partnership would not be disallowed by section 707, but will be disallowed to the extent provided in paragraph (b) of section 1.267(b)-1. See section 267 (a) and (b), and the regulations thereunder.

(c) Guaranteed payments.

Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of section 1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:
Example (1). Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example (3). Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example (4). Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.


Sec. 1.707-2 DISGUISED PAYMENTS FOR SERVICES.

[Reserved]

Sec. 1.707-3 DISGUISED SALES OF PROPERTY TO PARTNERSHIP; GENERAL RULES.

(a) Treatment of transfers as a sale

(1) In general.

Except as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1)
of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) Definition and timing of sale.

For purposes of sections 1.707-3 through 1.707-5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731, respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) of this section is treated as a sale for all purposes of the Code (e.g., sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

(3) Application of disguised sale rules.

If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules of this section that such person is not a partner. If after the application of the rules of this section to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes.

(4) Deemed terminations under section 708.

In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B) are disregarded.

(b) Transfers treated as a sale

(1) In general.

A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances-

(i) The transfer of money or other consideration would not have been made but for the transfer of property; and
(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) Facts and circumstances.

The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner’s right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner’s general and continuing interest in partnership profits; and
(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

(c) Transfers made within two years presumed to be a sale

(1) In general.

For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

(2) Disclosure of transfers made within two years.

Disclosure to the Internal Revenue Service in accordance with section 1.707-8 is required if --

(i) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period (without regard to the order of the transfers);

(ii) The partner treats the transfers other than as a sale for tax purposes; and

(iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under section 1.707-4(a)(1)(ii), is not a reasonable preferred return within the meaning of section 1.707-4(a)(3), and is not an operating cash flow distribution within the meaning of section 1.707-4(b)(2).

(d) Transfers made more than two years apart presumed not to be a sale.

For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

(e) Scope.

This section and sections 1.707-4 through 1.707-9 apply to contributions and distributions of property described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Internal Revenue Code.

(f) Examples.
The following examples illustrate the application of this section.

EXAMPLE 1. Treatment of simultaneous transfers as a sale.

A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that, under this section, the partnership’s transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted tax basis ($1,200,000 multiplied by $3,000,000/$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A’s capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted tax basis of $300,000.

EXAMPLE 2. Treatment of transfers at different times as a sale.

(i) The facts are the same as in EXAMPLE 1, except that the $3,000,000 is transferred to A one year after A’s transfer of property X to the partnership. Assume that under this section the partnership’s transfer of cash to A is treated as part of a sale of property X to the partnership. Assume also that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(ii) Under paragraph (a)(2) of this section, A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer $3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A’s amount realized from the receipt of the partnership’s obligation will be the imputed principal amount of the partnership’s obligation to transfer $3,000,000 to A, which equals $2,721,088 (the present value on April 9, 1992, of a $3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A’s amount realized from the receipt of the partnership’s obligation is $2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only $2,721,088 of the fair market value of property X. The remainder of the $3,000,000 payment ($278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize $1,904,761 of gain ($2,721,088 amount realized less $816,327 adjusted tax basis ($1,200,000 multiplied by $2,721,088/$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A’s capacity as a partner, $1,278,912 of the fair market value of property X with an adjusted tax basis of $383,673.

EXAMPLE 3. Operation of presumption for transfers within two years.
(i) C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. The partnership intends to construct a building on the land. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. The partnership agreement provides that upon completing construction of the building the partnership will distribute $900,000 to C.

(ii) If, within two years of C's transfer of land to the partnership, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be, under paragraph (c) of this section, part of a sale of the land to the partnership. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that --

(A) The transfer to C would have been made without regard to C's transfer of land to the partnership; or

(B) The partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

(iii) For example, if the partnership will be able to fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent loan to the cost of constructing the building (and thereby limits the partnership's ability to make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

(iv) Facts indicating that the transfer of cash to C is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund the transfer of cash to C may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash to C if the permanent loan proceeds are inadequate.

EXAMPLE 4. Operation of presumption for transfers within two years.

E is a partner in the equal EF partnership. The partnership owns two parcels of unimproved real property (parcels 1 and 2). Parcels 1 and 2 are unencumbered. Parcel 1 has a fair market value of $500,000, and parcel 2 has a fair market value of
$1,500,000. E transfers additional unencumbered, unimproved real property (parcel 3) with a fair market value of $1,000,000 to the partnership in exchange for an increased interest in partnership profits of 66-2/3 percent. Immediately after this transfer, the partnership sells parcel 1 for $500,000 in a transaction not in the ordinary course of business. The partnership transfers the proceeds of the sale $333,333 to E and $166,667 to F in accordance with their respective partnership interests. The transfer of $333,333 to E is presumed to be, in accordance with paragraph (c) of this section, a sale, in part, of parcel 3 to the partnership. However, the facts of this example clearly establish that $250,000 of the transfer to E is not part of a sale of parcel 3 to the partnership because E would have been distributed $250,000 from the sale of parcel 1 whether or not E had transferred parcel 3 to the partnership. The transfer to E exceeds by $83,333 ($333,333 minus $250,000) the amount of the distribution that would have been made to E if E had not transferred parcel 3 to the partnership. Therefore, $83,333 of the transfer is presumed to be part of a sale of a portion of parcel 3 to the partnership by E.

**EXAMPLE 5.** Operation of presumption for transfers more than two years apart.

(i) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. H contributes $1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is $5,000,000, which the partnership plans to fund with its $1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(ii) Shortly before G’s transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of $5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G’s transfer of the land. The amount of the permanent loan is to equal the lesser of $5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G’s transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed $5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost of $5,000,000 approximately two years after G’s transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of $5,000,000. At the time of funding the land and building have an appraised value of $7,000,000. The partnership transfers the $1,000,000 excess permanent loan proceeds to G 25 months after G’s transfer of the land to the partnership.

(iii) G’s transfer of the land to the partnership and the partnership’s transfer of $1,000,000 to G occurred more than two years apart. In accordance with paragraph (d) of this section, those transfers are presumed not to be a sale unless the facts
and circumstances clearly establish that the transfers constitute a sale of the property, in whole or part, to the partnership. The transfer of $1,000,000 to G would not have been made but for G's transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time an amount that equals the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of $1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

**EXAMPLE 6.** Rebuttal of presumption for transfers more than two years apart.

The facts are the same as in Example 5, except that the partnership is able to secure a commitment for a permanent loan in the amount of $5,000,000 without regard to the appraised value of the improved property at the time the permanent loan is funded. Under these facts, at the time that G transferred the land to the partnership the subsequent transfer of $1,000,000 to G was not dependent on the entrepreneurial risks of partnership operations, because during the period before the permanent loan is funded, the permanent lender's obligation to make a loan in the amount necessary to fund the transfer is not subject to contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the transfer. Therefore, the facts and circumstances clearly establish that G's transfer of the land to the partnership is part of a sale.

**EXAMPLE 7.** Operation of presumption for transfers more than two years apart.

The facts are the same as in Example 6, except that H does not guarantee either that the improvements will be completed or that the cost to the partnership of completing the improvements will not exceed $5,000,000. Under these facts, if there is a significant risk that the improvements will not be completed, G's transfer of the land to the partnership will not be treated as part of a sale because the lender is not required to make the permanent loan if the improvements are not completed. Similarly, the transfers will not be treated as a sale to the extent that there is a significant risk that the cost of constructing the improvements will exceed $5,000,000, because, in the absence of a guarantee of the cost of the improvements by H, the $5,000,000 proceeds of the permanent loan might not be sufficient to retire the construction loan and fund the transfer to G. In either case, the transfer of cash to G would be dependent on the entrepreneurial risks of partnership operations.

**EXAMPLE 8.** Rebuttal of presumption for transfers more than two years apart.

(i) On February 1, 1992, I, J, and K form partnership IJK. On formation of the partnership, I transfers an unencumbered office building with a fair market value of $50,000,000 and an adjusted tax basis of $20,000,000 to the partnership, and J and K each transfer United States government securities with a fair market value and an adjusted tax basis of $25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis. The partnership
agreement provides that all items of income, gain, loss, and deduction from the office building are to be allocated 45 percent to J, 45 percent to K, and 10 percent to I. The partnership agreement also provides that all items of income, gain, loss, and deduction from the government securities are to be allocated 90 percent to I, 5 percent to J, and 5 percent to K. The partnership agreement requires that cash flow from the office building and government securities be allocated between partners in the same manner as the items of income, gain, loss, and deduction from those properties are allocated between them. The partnership agreement complies with the requirements of section 1.704-1(b)(2)(ii)(b). It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the office building. At the time the partnership is formed, I, J, and K contemplated that I’s interest in the partnership would be liquidated sometime after January 31, 1994, in exchange for a transfer of the government securities and cash (if necessary). On March 1, 1995, the partnership transfers cash and the government securities to I in liquidation of I’s interest in the partnership. The cash transferred to I represents the excess of I’s share of the appreciation in the office building since the formation of the partnership over J’s and K’s share of the appreciation in the government securities since they were acquired by the partnership.

(ii) I’s transfer of the office building to the partnership and the partnership’s transfer of the government securities and cash to I occurred more than two years apart. Therefore, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Absent I’s transfer of the office building to the partnership, I would not have received the government securities from the partnership. The facts (including the amount and nature of partnership assets) indicate that, at the time that I transferred the office building to the partnership, the timing of the transfer of the government securities to I was anticipated and was not dependent on the entrepreneurial risks of partnership operations. Moreover, the facts indicate that the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of the transfer of those securities to I and those burdens and benefits were effectively shifted to I on formation of the partnership. Accordingly, the facts and circumstances clearly establish that I sold the office building to the partnership on February 1, 1992, in exchange for the partnership’s obligation to transfer the government securities to I and to make certain other cash transfers to I.


Sec. 1.707-4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.

(a) Guaranteed payments and preferred returns

(1) Guaranteed payment not treated as part of a sale
(i) In general.

A guaranteed payment for capital made to a partner is not treated as part of a sale of property under section 1.707-3(a) (relating to treatment of transfers as a sale). A party's characterization of a payment as a guaranteed payment for capital will not control in determining whether a payment is, in fact, a guaranteed payment for capital. The term **GUARANTEED PAYMENT FOR CAPITAL** means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. See section 707(c). For this purpose, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.

(ii) Reasonable guaranteed payments.

Notwithstanding the presumption set forth in section 1.707-3(c) (relating to transfers made within two years of each other), for purposes of section 707(a)(2) and the regulations thereunder a transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership and is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iii) Unreasonable guaranteed payments.

A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital but that is not reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital. A transfer that is not a guaranteed payment for capital is subject to the rules of section 1.707-3.

(2) Presumption regarding reasonable preferred returns.

Notwithstanding the presumption set forth in paragraph (c) of section 1.707-3 (relating to transfers made within two years of each other), a transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be part of a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term **PREFERRED RETURN** means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.

(3) Definition of reasonable preferred returns and guaranteed payments
(i) In general.

A transfer of money to a partner that is characterized as a preferred return or guaranteed payment for capital is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

(ii) Reasonable amount.

A transfer of money that is made to a partner during any partnership taxable year and is characterized as a preferred return or guaranteed payment for capital is reasonable in amount if the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, transfers of money that are reasonable preferred returns within the meaning of this paragraph (a)(3), and operating cash flow distributions within the meaning of paragraph (b)(2) of this section.

(4) Examples.

The following examples illustrate the application of paragraph (a) of this section:

EXAMPLE 1. Transfer presumed to be a guaranteed payment.

(i) A transfers property with a fair market value of $100,000 to partnership AB. At the time of A's transfer, the partnership agreement is amended to provide that A is to receive a guaranteed payment for the use of A's capital of 10 percent (compounded annually) of the fair market value of the transferred property in each of the three years following the transfer. The partnership agreement provides that partnership net taxable income and loss will be allocated equally between partners A and B, and that partnership cash flow will be distributed in
accordance with the allocation of partnership net taxable income and loss. The partnership would be allowed a deduction in the year paid if the transfers made to A are treated as guaranteed payments under section 707(c). Under the partnership agreement, that deduction would be allocated in the same manner as any other item of partnership deduction. The partnership agreement complies with the requirements of section 1.704-1(b)(2)(ii)(b). The partnership agreement does not provide for the payment of a preferred return and, other than the guaranteed payment to be paid to A, no transfer is expected to be made during the three year period following A's transfer that is not an operating cash flow distribution (within the meaning of paragraph (b)(2) of this section). Assume that the highest applicable Federal rate in effect at the time of A's transfer is eight percent compounded annually.

(ii) The transfer of money to be made to A under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of section 1.707-4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in section 1.707-3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital but is part of a sale.

(iii) The presumption that the transfer is a guaranteed payment for capital is not rebutted, because there are no facts indicating that the transfer is not a guaranteed payment for the use of capital.

EXAMPLE 2. Transfers characterized as guaranteed payments treated as part of a sale.

(i) C and D form partnership CD. C transfers property with a fair market value of $100,000 and an adjusted tax basis of $20,000 in exchange for a partnership interest. D is responsible for managing the day-to-day operations of the partnership and makes no capital contribution to the partnership upon its formation. The partnership agreement provides that C is to receive payments characterized as guaranteed payments and determined without regard to partnership income of $8,333 per year for the first four years of partnership operations for the use of C's capital. In addition, the partnership agreement provides that --

(1) Partnership net taxable income and loss will be allocated 75 percent to C and 25 percent to D; and

(2) All partnership cash flow (determined prior to consideration of the guaranteed payment) will be distributed 75 percent to C and 25 percent to D except that guaranteed payments that the partnership is obligated to make to C are payable solely out of D's share of the partnership's cash flow.

(ii) If D's share of the partnership's cash flow is not sufficient to make the guaranteed payment to C, then D is obligated to contribute any shortfall to the partnership, even in the event the partnership is liquidated. Thus, the effect of
the guaranteed payment arrangement is that the guaranteed payment to C is funded entirely by D. The partnership agreement complies with the requirements of section 1.704-1(b)(2)(ii)(b). Assume that, at the time the partnership is formed, the partnership or D could borrow $25,000 pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12 percent (compounded annually). Assume that the highest applicable Federal rate in effect at the time the partnership is formed is 10 percent compounded annually.

(iii) The transfer of money to be made to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of section 1.707-4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in section 1.707-3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iv) For the first four years of partnership operations, the total guaranteed payments made to C under the partnership agreement will equal $33,332. If the characterization of those payments as guaranteed payments for capital within the meaning of section 707(c) were respected, C would be allocated $24,999 of the deductions that would be claimed by the partnership for those payments, thereby leaving the balance in C's capital account approximately $25,000 less than it would have been if the guaranteed payments had not been made. The guaranteed payments thus have the effect of offsetting approximately $25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's resulting capital account is approximately equivalent to the capital account C would have had if C had only contributed 75 percent of the property to the partnership. Furthermore, the effect of D's funding the guaranteed payment to C (either through reduced distributions of cash flow to D or additional contributions) is that D's capital account is approximately equivalent to the capital account D would have had if D had contributed 25 percent of the property (or contributed cash so that the partnership could purchase the 25 percent). Moreover, a $25,000 loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of 12 percent (compounded annually), would have resulted in annual payments of principal and interest of $8,230.86. Consequently, the guaranteed payments effectively place the partners in the same economic position that they would have been in had D purchased a one-quarter interest in the property from C financed at the current market rate of interest, and then C and D each contributed their share of the property to the partnership. In view of the burden the guaranteed payments place on D's right to transfers of partnership cash flow and D's legal obligation to make contributions to the partnership to the extent necessary to fund the guaranteed payments, D has effectively purchased through the partnership a one-quarter interest in the property from C.

(v) Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly
establish that the transfers are part of a sale and not guaranteed payments for capital. Under section 1.707-3(a), C and the partnership are treated as if C sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership’s obligation to make the guaranteed payments.

(b) Presumption regarding operating cash flow distributions

(1) In general.

Notwithstanding the presumption set forth in section 1.707-3(c) (relating to transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.

(2) Operating cash flow distributions

(i) In general.

One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner’s percentage interest in overall partnership profits for that year or the partner’s percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership’s business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by --

(A) Principal payments made on any partnership indebtedness;

(B) Property replacement or contingency reserves actually established by the partnership;

(C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and

(D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

(ii) Operating cash flow safe harbor.
For any taxable year, in determining a partner's operating cash flow distributions for the year the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

(iii) Tiered partnerships.

In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in paragraph (b)(2)(i) of this section, so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated.

(c) Accumulation of guaranteed payments, preferred returns, and operating cash flow distributions.

Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the rules of paragraphs (a) and (b) of this section do not lose the benefit of the presumption by reason of being retained for distribution in a later year.

(d) Exception for reimbursements of preformation expenditures.

A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under section 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that --

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to --

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

(e) Other exceptions.
The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other payments or transfers to a partner are not treated as part of a sale for purposes of section 707(a)(2) and the regulations thereunder.


Sec. 1.707-5 DISGUISED SALES OF PROPERTY TO PARTNERSHIP; SPECIAL RULES RELATING TO LIABILITIES.

(a) Liability assumed or taken subject to by partnership

(1) In general.

For purposes of this section and sections 1.707-3 and 1.707-4, if a partnership assumes or takes property subject to a qualified liability (as defined in paragraph (a)(6) of this section) of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in paragraphs (a)(2), (3) and (4) of this section.

(2) Partner's share of liability.

A partner's share of any liability of the partnership is determined under the following rules:

(i) Recourse liability.

A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under section 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) Nonrecourse liability.

A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under section 1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under section 1.752-1(a)(2) or would be a nonrecourse liability of the partnership under section 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

(3) Reduction of partner's share of liability.
For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if --

(i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and

(ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under section 1.707-3.

(4) Special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan.

For purposes of paragraph (a)(1) of this section, if the partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities, as defined in paragraph (a)(8) of this section) assumed or taken subject to by the partnership pursuant to the plan. This paragraph (a)(4) does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as a transfer of consideration under paragraph (a)(1) of this section.

(5) special rule applicable to qualified liabilities.

(i) If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale. If a transfer of property by a partner to the partnership is treated as part of a sale without regard to the partnership's assumption of or taking subject to a qualified liability (as defined in paragraph (a)(6) of this section) in connection with the transfer of property, the partnership's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partnership only to the extent of the lesser of --

(A) The amount of consideration that the partnership would be treated as transferring to the partner under paragraph (a)(1) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to that property.

(ii) A partner's net equity percentage with respect to an item of property equals the percentage determined by dividing --
(A) The aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer described in this paragraph (a)(5)) that are treated as proceeds realized from the sale of the transferred property; by

(B) The excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property or, in the case of any qualified liability described in paragraph (a)(6)(i)(C) or (D) of this section, that is properly allocable to the property.

(6) Qualified liability of a partner defined.

A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability of the partner only to the extent -

(i) The liability is --

(A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of section 1.163-8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i)(C) or (D) of this section) at the time of the transfer.

(7) Liability incurred within two years of transfer presumed to be in anticipation of the transfer --

(i) In general.
For purposes of this section, if within a two-year period a partner incurs a liability (other than a liability described in paragraph (a)(6)(i)(C) or (D) of this section) and transfers property to a partnership or agrees in writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.

(ii) Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.

If a partner treats a liability assumed or taken subject to by a partnership as a qualified liability under paragraph (a)(6)(i)(B) of this section, such treatment is to be disclosed to the Internal Revenue Service in accordance with section 1.707-8.

(b) Treatment of debt-financed transfers of consideration by partnerships

(1) In general.

For purposes of section 1.707-3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under section 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

(2) Partner's allocable share of liability

(i) In general.

A partner's allocable share of a partnership liability for purposes of paragraph (b)(1) of this section equals the amount obtained by multiplying the partner's share of the liability as described in paragraph (a)(2) of this section by the fraction determined by dividing --

(A) The portion of the liability that is allocable under section 1.163-8T to the money or other property transferred to the partner; by

(B) The total amount of the liability.

(ii) Debt-financed transfers made pursuant to a plan.

(A) In general.

Except as provided in paragraph (b)(2)(iii) of this section, if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, paragraph (b)(1) of this section is applied by treating all of the liabilities incurred pursuant to the plan as one liability, and each partner's allocable share of those liabilities equals the amount obtained by multiplying the sum of the
partner’s shares of each of the respective liabilities (as defined in paragraph (a)(2) of this section) by the fraction obtained by dividing --

(1) The portion of those liabilities that is allocable under section 1.163-8T to the money or other consideration transferred to the partners pursuant to the plan; by

(2) The total amount of those liabilities.

(B) Special rule.

Paragraph (b)(2)(ii)(A) of this section does not apply to any transfer of money or other property to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under paragraph (b)(1) of this section.

(iii) Reduction of partner’s share of liability.

For purposes of paragraph (b)(2) of this section, a partner’s share of a liability, immediately after the partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner’s share if --

(A) It is anticipated that the partner’s share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; and

(B) The reduction of the partner’s share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership’s distribution of the proceeds of the borrowing is treated as part of a sale.

(c) Refinancings.

To the extent that the proceeds of a partner or partnership liability (the REFINANCING DEBT) are allocable under the rules of section 1.163-8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying the rules of this section.

(d) Share of liability where assumption accompanied by transfer of money.

For purposes of sections 1.707-3 through 1.707-5, if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced (but not below zero) by the money transferred.

(e) Tiered partnerships and other related persons.
If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin.

(f) Examples.

The following examples illustrate the application of this section.

EXAMPLE 1. Partnership's assumption of nonrecourse liability encumbering transferred property.

(i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, an adjusted basis of $400,000, and is encumbered by a $500,000 liability, which B incurred 12 months earlier to finance the acquisition of other property. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse deductions under section 1.752-3(a)(3). The partnership agreement complies with the requirements of section 1.704-1(b)(2)(ii)(b).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability equals $250,000, which is equal to B's 50 percent share of the excess nonrecourse liability of the partnership as determined in accordance with B's share of partnership profits under section 1.752-3(a)(3).

(iii) The partnership's taking subject to the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after taking subject to ($250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's taking subject to a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).

EXAMPLE 2. Partnership’s assumption of recourse liability encumbering transferred property.

(i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under section 752
and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.

(ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability. Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)). See paragraphs (a)(1) and (2) of this section.

EXAMPLE 3. Subsequent reduction of transferring partner's share of liability.

(i) The facts are the same as in EXAMPLE 2. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, and the reduction was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under section 1.707-3 (i.e., a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

EXAMPLE 4. Trade payables as qualified liabilities.

(i) D and E form partnership DE which will engage in a consulting business that requires no overhead and minimal cash on hand for daily operating expenses. Previously, D and E, as individual sole proprietors, operated separate consulting businesses. D and E each transfer to the partnership sufficient cash to cover daily operating expenses together with the goodwill and trade payables related to each sole proprietorship. Due to uncertainty over the collection rate on the trade receivables related to their sole proprietorships, D and E agree that none of the trade receivables will be transferred to the partnership.

(ii) Under the facts of this example, all the assets related to the consulting business (other than the trade receivables) together with the trade payables were transferred to partnership DE. The trade receivables retained by D and E are not material to a continuation of the trade or business by the partnership because D and E contributed sufficient cash to cover daily operating expenses. Accordingly, the trade payables transferred to the partnership constitute qualified liabilities under paragraph (a)(6) of this section.

EXAMPLE 5. Partnership's assumption of a qualified liability as sole consideration.

(i) F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax
basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that, under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Z, the liability is a recourse liability of the partnership and F's share of that liability is $25,000.

(ii) The $75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the assumption of the liability by the partnership and the liability has encumbered property Z for more than two years prior to that assumption. See paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

**EXAMPLE 6.** Partnership's assumption of a qualified liability in addition to other consideration.

(i) The facts are the same as in EXAMPLE 5, except that the partnership makes a transfer to D of $30,000 in money that is consideration for F's transfer of property Z to the partnership under section 1.707-3.

(ii) As in EXAMPLE 5, the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of --

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 (i.e., the excess of the $75,000 qualified liability over F's $25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing --

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under section 1.707-3 (a) ($30,000 transfer of money); by

(B) F's net equity in property Z ($90,000 (i.e., the excess of the $165,000 fair market value over the $75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability.
Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000 of F's adjusted basis for property Z (i.e., one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

EXAMPLE 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan.

(i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $10,000 and an adjusted tax basis of $6,000, and property 2 has a fair market value of $10,000 and an adjusted tax basis of $4,000. At the time properties 1 and 2 are transferred to the partnership, a $6,000 nonrecourse liability (LIABILITY 1) is secured by property 1 and a $7,000 recourse liability of F (LIABILITY 2) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated $2,000 of liability 1 in accordance with section 1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is $3,500 and H's share is $0 in accordance with section 1.707-5(a)(2)(i) (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only $500 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liabilities 1 and 2 ($5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only $5,000 of consideration to H (the amount by which liability 2 ($7,000) exceeds H's share of liabilities 1 and 2 ($2,000)). G is treated under the rule in section 1.707-3 as having sold $500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold $5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

EXAMPLE 8. Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability.

(i) The facts are the same as in EXAMPLE 7, except that --

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of $4,000 of consideration to G (the amount by which liability 1 ($6,000)
exceeds G’s share of liability 1 ($2,000)). On the other hand, the partnership’s assumption of liability 2 is not treated as a transfer of any consideration to H because H’s share of that liability equals $7,000 as a result of H’s transfer of $7,000 in money to the partnership.

EXAMPLE 9. Partnership’s assumptions of qualified liabilities encumbering properties transferred pursuant to a plan in addition to other consideration.

(i) pursuant to a plan, I transfers property 1 and J transfers property 2 plus $10,000 in cash to partnership IJ in exchange for equal interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $50,000 (LIABILITY 1). Property 2 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $70,000 (LIABILITY 2). Pursuant to the plan, the partnership transferred to I $10,000 in cash. That amount is consideration for I’s transfer of property 1 to the partnership under section 1.707-3. In accordance with section 1.707-5(a)(2), I and J are each allocated $25,000 of liability 1 and $35,000 of liability 2.

(ii) Because the partnership transferred $10,000 to I as consideration for the transfer of property, under section 1.707-5(a)(5), the partnership’s assumption of liability 1 is treated as a transfer of additional consideration to I, even though liability 1 is a qualified liability, to the extent of the lesser of --

(A) The amount that the partnership would be treated as transferring to I if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the qualified liability by I’s net equity percentage with respect to property 1.

(iii) Because I and J transferred properties 1 and 2 to the partnership pursuant to a plan, treating I’s qualified liability as a nonqualified liability under section 1.707-5(a)(5)(i)(A) enables I to apply the special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan under section 1.707-5(a)(4). Under this alternative test, the partnership’s assumption of liability 1 encumbering property 1 is treated as a transfer of zero ($0) additional consideration to I pursuant to a sale. This is because the amount of liability 1 ($50,000) does not exceed the sum of I’s share of liability 1 treated as a nonqualified liability ($25,000) and I’s share of liability 2 ($35,000)).

(iv) The alternative under section 1.707-5(a)(5)(i)(B) is the amount obtained by multiplying the qualified liability ($50,000) by I’s net equity percentage with respect to property 1. I’s net equity percentage with respect to property 1 equals one-fifth, the fraction determined by dividing --

(1) The aggregate amount of money or other consideration (other than the qualified liability) transferred to I and treated as part of a sale of property 1 under section 1.707-3(a) (the $10,000 transfer of money); by

(2) I’s net equity in property 1 ($50,000, i.e., the excess of the $100,000 fair market value over the $50,000 qualified liability).
(v) Under this alternative test, the partnership's assumption of the qualified liability encumbering property 1 is treated as a transfer of $10,000 (one-fifth of the $50,000 qualified liability) of additional consideration to I pursuant to a sale.

(vi) Applying section 1.707-5(a)(5) to these facts,

   the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I to the extent of the lesser of --

   (A) zero; or

   (B) $10,000.

(vii) Therefore, the partnership's assumption of I's qualified liability encumbering property 1 is not treated as a transfer of any additional consideration to I pursuant to a sale, and I is treated as having only received $10,000 of the fair market value of property 1 to the partnership in exchange for $10,000 in cash. Accordingly, I must recognize $9,500 of gain on the sale, that is, the excess of the $10,000 amount realized over $500 of I's adjusted tax basis for property 1 (one-tenth of I's adjusted tax basis for the property, because I is treated as having sold one-tenth of the property to the partnership). Since no other transfer to J was made as consideration for the transfer of property 2, the partnership's assumption of the qualified liability of J encumbering property 2 is not treated as part of a sale.

EXAMPLE 10. Treatment of debt-financed transfers of consideration by partnership.

(i) K transfers property Z to partnership KL in exchange for an interest therein on April 9, 1992. On September 13, 1992, the partnership incurs a liability of $20,000. On November 17, 1992, the partnership transfers $20,000 to K, and $10,000 of this transfer is allocable under the rules of section 1.163-8T to proceeds of the partnership liability incurred on September 13, 1992. The remaining $10,000 is paid from other partnership funds. Assume that, under section 752 and the corresponding regulations, the $20,000 liability incurred on September 13, 1992, is a recourse liability of the partnership and K's share of that liability is $10,000 on November 17, 1992.

(ii) Because a portion of the transfer made to K on November 17, 1992, is allocable under section 1.163-8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and section 1.707-3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing --

   (A) The amount of the liability that is allocable to the distribution to K ($10,000); by

   (B) The total amount of such liability ($20,000)).

(iii) Therefore, K is required to take into account

   only $15,000 of the $20,000 partnership transfer to K for purposes of this section and section 1.707-3. Under these facts, assuming the within-two-year presumption is
not rebutted, this $15,000 transfer will be treated under the rule in section 1.707-3 as part of a sale by K of property Z to the partnership.

**EXAMPLE 11.** Borrowing against pool of receivables.

(i) M generates receivables which have an adjusted basis of zero in the ordinary course of its business. For M to use receivables as security for a loan, a commercial lender requires M to transfer the receivables to a partnership in which M has a 90 percent interest. In January, 1992, M transfers to the partnership receivables with a face value of $100,000. N (who is not related to M) transfers $10,000 cash to the partnership in exchange for a 10 percent interest. The partnership borrows $80,000, secured by the receivables, and makes a distribution of $72,000 of the proceeds to M and $8,000 of the proceeds to N within 90 days of incurring the liability. M's share of the liability under section 1.707-5(a)(2) is $72,000 (90 percent x $80,000).

(ii) Because the transfer of the loan proceeds to M is allocable under section 1.163-8T to proceeds of a partnership loan that was incurred by the partnership within 90 days of that transfer, M is required to take the transfer into account in applying the rules of this section and section 1.707-3 only to the extent that the amount of the transfer ($72,000) exceeds M's allocable share of the liability used to fund the transfer. Because the distribution was a debt-financed transfer pursuant to a plan, M's allocable share of the liability is $72,000 ($72,000 x $80,000/80,000) under section 1.707-5(b)(2)(ii). Therefore, M is not required to take into account any of the loan proceeds for purposes of this section and section 1.707-3.

(iii) When the receivables are collected, M must be allocated the gain on the contributed receivables under section 704 (c). However, the lender permits the partnership to distribute cash to the partners only to the extent of the value of new receivables contributed to the partnership. In 1993, M contributes additional receivables and receives a distribution of cash. The taxable income recognized by the partnership on the receivables is taxable income of the partnership arising in the ordinary course of the partnership's activities. To the extent the distribution does not exceed 90 percent (M's percentage interest in overall partnership profits) of the partnership's operating cash flow under section 1.707-4(b), the distribution to M is presumed not to be a part of a sale of receivables by M to the partnership, and the presumption is not rebutted under these facts.


**Sec. 1.707-6 DISGUISED SALES OF PROPERTY BY PARTNERSHIP TO PARTNER; GENERAL RULES.**

(a) In general.

Rules similar to those provided in section 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

(b) Special rules relating to liabilities

(1) In general.
Rules similar to those provided in section 1.707-5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale. Accordingly, if a partner assumes or takes property subject to a qualified liability (as defined in paragraph (b)(2) of this section) of a partnership, the partner is treated as transferring consideration to the partnership only to the extent provided in this paragraph (b). If the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability (determined under the rules of section 1.707-5(a)(2)) immediately before the transfer. Similar to the rules provided in section 1.707-5(a)(4), if more than one partner assumes or takes subject to a liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of the liabilities (other than qualified liabilities) assumed or taken subject to by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption or taking subject to. This paragraph (b)(1) does not apply to any liability assumed or taken subject to by a partner with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by a partner is treated as a transfer of consideration under paragraph (b) of this section.

(2) Qualified liabilities.

(i) If a transfer of property by a partnership to a partner is not otherwise treated as part of a sale, the partner's assumption of or taking subject to a qualified liability is not treated as part of a sale. If a transfer of property by a partnership to the partner is treated as part of a sale without regard to the partner's assumption of or taking subject to a qualified liability, the partner's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partner only to the extent of the lesser of --

(A) The amount of consideration that the partner would be treated as transferring to the partnership under paragraph (b) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the liability at the time of its assumption or taking subject to by the partnership's net equity percentage with respect to that property.

(ii) A partnership's net equity percentage with respect to an item of property encumbered by a qualified liability equals the percentage determined by dividing --

(A) The aggregate transfers to the partnership from the partner (other than any transfer described in this paragraph (b)(2)) that are treated as the proceeds realized from the sale of the transferred property to the partner; by
(B) The excess of the fair market value of the property at the time it is transferred to the partner over any qualified liabilities of the partnership that are assumed or taken subject to by the partner at that time.

(iii) For purposes of this section, the definition of a qualified liability is that provided in section 1.707-5(a)(6) with the following exceptions --

(A) In applying the definition, the qualified liability is one that is originally an obligation of the partnership and is assumed or taken subject to by the partner in connection with a transfer of property to the partner; and

(B) If the liability was incurred by the partnership more than two years prior to the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner, that liability is a qualified liability whether or not it has encumbered the transferred property throughout the two-year period.

(c) Disclosure rules.

Similar to the rules provided in sections 1.707-3(c)(2) and 1.707-5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with section 1.707-8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to section 1.707-5(a)(6)(i)(B).

(d) Examples.

The following examples illustrate the rules of this section.

**EXAMPLE 1.** Sale of property by partnership to partner.

(i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.
(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in section 1.707-3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A’s obligation to transfer $1,100,000 to the partnership one year later.

EXAMPLE 2. Assumption of liability by partner.

(i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under the rule of section 1.707-5(a)(2)(ii) (which determines a partner’s share of a nonrecourse liability), B’s share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of section 1.163-8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in section 1.707-5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B’s share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B’s capacity as a partner, the other one-half of property Y.


Sec. 1.707-7 DISGUISED SALES OF PARTNERSHIP INTERESTS.

[Reserved]


Sec. 1.707-8 Disclosure of certain information.

(a) In general.

The disclosure referred to in section 1.707-3(c)(2) (regarding certain transfers made within two years of each other), section 1.707-5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and section 1.707-6(c) (relating to transfers of property from a partnership to a partner in situations
analogous to those listed above) is to be made in accordance with paragraph (b) of this section.

(b) Method of providing disclosure.

Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:

1. A caption identifying the statement as disclosure under section 707;
2. An identification of the item (or group of items) with respect to which disclosure is made;
3. The amount of each item; and
4. The facts affecting the potential tax treatment of the item (or items) under section 707.

(c) Disclosure by certain partnerships.

If more than one partner transfers property to a partnership pursuant to a plan, the disclosure required by this section may be made by the partnership on behalf of all the transferors rather than by each transferor separately.


Sec. 1.707-9 EFFECTIVE DATES AND TRANSITIONAL RULES.

(a) Sections 1.707-3 through 1.707-6

1. In general.

Except as provided in paragraph (a)(3) of this section, sections 1.707-3 through 1.707-6 apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991.

2. Transfers occurring on or before April 24, 1991.

Except as otherwise provided in paragraph (a)(3) of this section, in the case of any transaction with respect to which one or more of the transfers occurs on or before April 24, 1991, the determination of whether the transaction is a disguised sale of property (including a partnership interest) under section 707(a)(2) is to be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 73 of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 494). See H.R. Rep. No. 861, 98th Cong., 2d Sess. 859-62 (1984); H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216-21 (1984).

Sections 1.707-3 through 1.707-6 do not apply to any transfer of money or other consideration to which section 73(a) of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 494) does not apply pursuant to section 73(b) of that Act.

(b) Section 1.707-8 disclosure of certain information.

The disclosure provisions described in section 1.707-8 apply to transactions with respect to which all transfers that are part of a sale of property occur after September 30, 1992.


Sec. 1.708-1 Continuation of partnership.

(a) General rule.

For purposes of Subchapter K, Chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination--

(1) General rule.

(i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956.

(ii) A partnership shall terminate when 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest),

(a) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(b) For the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), see paragraph (a)(6) of section 1.736-1.
bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph. Moreover, if the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership’s interest in the capital and profits of the lower-tier partnership. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner. Furthermore, the contribution of property to a partnership does not constitute such a sale or exchange. See, however, paragraph (c)(3) of section 1.731-1. Fifty percent or more of the total interest in partnership capital and profits means 50 percent or more of the total interest in partnership capital plus 50 percent or more of the total interest in partnership profits. Thus, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If one or more partners sell or exchange interests aggregating 50 percent or more of the total interest in partnership capital and profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of this subparagraph. When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale. For example, with respect to the ABC partnership, the sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of a 50-percent or more interest. Accordingly, the partnership is terminated as of March 27, 1957. However, if, on March 27, 1957, D instead of B, sold his 30-percent interest in capital and profits to E, there would be no termination since only one 30-percent interest would have been sold or exchanged within a 12-month period.

(iii) For purposes of Subchapter K, Chapter 1 of the Code, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See section 706(c)(1) and paragraph (c)(1) of section 1.706-1. The date of termination is:

(a) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

(b) For purposes of section 708(b)(1)(B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50 percent or more in both partnership capital and profits.
(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with (b)(1)(i) of this section. This paragraph (b)(1)(iv) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(1)(iv) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(1)(iv) to the termination in a consistent manner. The provisions of this paragraph (b)(1)(iv) are illustrated by the following example:

Example. (i) A and B each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time A sells its entire 50 percent interest to C for $15,000 in a transfer that terminates the partnership under section 708(b)(1)(B). At the time of the sale, Property X had an adjusted tax basis of $16,000 and a book value of $16,000 (original $20,000 tax basis and book value reduced by $4,000 of depreciation). In addition, A and B each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

(ii) Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is $16,000. See Section 723. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). See section 1.704-1(b)(2)(iv)(l) (providing that the deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership). Additionally, under section 301.6109-1(d)(2)(iii) of this chapter, new AB retains the taxpayer identification number of the terminated AB partnership.

(iii) Property X was not section 704(c) property in the hands of terminated AB and is therefore not treated as section 704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the fair market value of Property X ($30,000) was different from its adjusted tax basis ($16,000). See section 1.704-3(a)(3)(i) (providing that property contributed to a new partnership under section 1.708-1(b)(1)(iv) is treated as section 704(c) property only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination).
(v) If a partnership is terminated by a sale or exchange of an interest in the partnership, a section 754 election (including a section 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted pursuant to sections 743 and 755 prior to their deemed contribution to the new partnership. This paragraph (b)(1)(v) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(1)(v) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(1)(v) to the termination in a consistent manner.

(2) Special rules--

(i) Merger or consolidation.

If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation of that partnership which is credited with the contribution of the greatest dollar value of assets to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results. The taxable years of such merging or consolidating partnerships which are considered terminated shall be closed in accordance with the provisions of section 706(c), and such partnerships shall file their returns for a taxable year ending upon the date of termination, i.e., the date of merger or consolidation. The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership and shall include the names and addresses of the merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and subsequent to the date of merger or consolidation shall be shown as a part of the return. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, 1955, and form partnership ABCD. Partners A, B, C, and D are on a calendar year; partnership AB is also on a calendar year; and partnership CD is on a fiscal year ending June 30th. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in
the capital and profits of partnership ABCD, such partnership shall be considered a continuation of partnership AB and shall continue to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, 1955, the date of the merger, and CD partnership is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that, until September 30, 1955, it was partnership AB. Partnership CD is required to file a return for its final taxable year, July 1 through September 30, 1955.

(ii) Division of a partnership.

Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships shall be considered a continuation of the prior partnership if its members had an interest of more than 50 percent in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the divided partnership, the divided partnership is terminated. Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such partner's interests shall be considered liquidated as of the date of the division. The resulting partnership that is regarded as continuing shall file a return for the taxable year of the partnership that has been divided. The return shall state that the partnership is a continuation of the divided partnership and shall set forth separately the respective distributive shares of the partners for the periods prior to and subsequent to the date of division. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership ABCD is in the real estate and insurance business. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. They agree to separate the real estate and insurance business as of November 1, 1955, and to form two partnerships; partnership AB to take over the real estate business, and partnership CD to take over the insurance business. Since members of resulting partnership AB owned more than a 50-percent interest in the capital and profits of partnership ABCD (A, 40 percent, and B, 20 percent), partnership AB shall be considered a continuation of partnership ABCD. Partnership AB is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that until November 1, 1955, it was partnership ABCD. In forming partnership CD, partners C and D may contribute the property distributed to them in liquidation of their entire interests in divided partnership ABCD. Partnership CD will be required to file a return for the taxable year it adopts pursuant to section 706(b) and paragraph (b) of section 1.706-1.

[Amended by T.D. 8717, 62 FR 25498-25502, May 9, 1997.]
Sec. 1.709-1 Treatment of organization and syndication costs.

(a) General rule.

Except as provided in paragraph (b) of this section, no deduction shall be allowed under Chapter 1 of the Code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) Amortization of organization expenses.

(1) Under section 709(b) of the Code, a partnership may elect to treat its organizational expenses (as defined in section 709(b)(2) and in section 1.709-2(a)) paid or incurred in partnership taxable years beginning after December 31, 1976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight line basis. This period must begin with the month in which the partnership begins business (as determined under section 1.709-2(c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses that have not been paid by the end of that taxable year. Portions of such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses had been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed.

(2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to its capitalized syndication expenses.

(c) Time and manner of making election.

The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnership's return of income for the taxable year in which the partnership begins business. The statement shall set forth a description of each organizational expense incurred (whether or not paid) with the amount of the expense, the date each expense was incurred, the month in which the partnership began business, and the number of months (not less than 60) over which the expenses are to be amortized. A taxpayer on the cash receipts and disbursements method of accounting shall also indicate the amount paid before the end of the taxable year with respect to each such expense. Expenses less than $10 need not be separately listed, provided the total amount of these expenses is listed with the dates on which the first and last of such expenses were incurred, and, in the case of a taxpayer on the cash receipts and disbursements method of accounting, the aggregate amount of such expenses that was paid by the end of the taxable year is stated. In the case of a partnership which begins business in a taxable year
that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnership’s original return and statement.


Sec. 1.709-2 Definitions.

(a) Organizational expenses.

Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses which:

1. Are incident to the creation of the partnership;
2. Are chargeable to capital account; and
3. Are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a)) be amortized over such life.

An expenditure which fails to meet one or more of these three tests does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) Syndication expenses.
Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) Beginning business.

The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily, a partnership begins business when it starts the business operations for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business.

If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term "operating assets", as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.


Sec. 1.721-1 Nonrecognition of gain or loss on contribution.

(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of section 1.731-1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and section 1.752-1.
(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

(c) Underwritings of partnership interests --

(1) In general.

For the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory.

(2) Effective date.

This paragraph (c) is effective for qualified underwriting transactions occurring on or after May 1, 1996.

[Amended by T.D. 8665, 61 FR 19188-19189, May 1, 1996.]

Sec. 1.722-1 Basis of contributing partner’s interest.

The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition of an interest in partnership capital results in taxable income to a partner, such income
shall constitute an addition to the basis of the partner's interest. See paragraph (b) of section 1.721-1. If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. See section 752 and section 1.752-1. The provisions of this section may be illustrated by the following examples:

**Example (1).** A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

- **Adjusted basis to A of property contributed** $4,000
- **Less portion of mortgage assumed by other partners which must be treated as a distribution (80% of $2,000)** 1,600
- **Basis of A's interest** $2,400

**Example (2).** If, in example (1) of this section, the property contributed by A was subject to a mortgage of $6,000, the basis of A's interest would be zero, computed as follows:

- **Adjusted basis to A of property contributed** $4,000
- **Less portion of mortgage assumed by other partners which must be treated as a distribution (80% of $6,000)** 4,800

Since A's basis cannot be less than zero, the $800 in excess of basis, which is considered as a distribution of money under section 752(b), is treated as capital gain from the sale or exchange or a partnership interest. See section 731(a).

**Sec. 1.723-1 Basis of property contributed to partnership.**

The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223(2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see sections 732(d), 734(b), and 743(b).

**Sec. 1.731-1 Extent of recognition of gain or loss on distribution.**

(a) Recognition of gain or loss to partner--

(1) Recognition of gain.
(i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i.e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of cash of $8,000 and property with a fair market value of $3,000, no gain is recognized to him. If $11,000 cash were distributed, gain would be recognized to the extent of $1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items). See section 731(c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) Recognition of loss.

Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751(c)), and inventory items (as defined in section 751(d)(2)). The term "liquidation of a partner's interest", as defined in section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of:

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a partnership interest in partnership ABC with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $5,000 cash and inventory with a basis to him (under section 732) of $3,000. Partner A realizes a capital loss of $2,000, which is recognized under section 731(a)(2).

Example (2). Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and
receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

(3) Character of gain or loss.

Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) Gain or loss recognized by partnership.

A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) Exceptions.

(1) Section 731 does not apply to the extent otherwise provided by:

   (i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest) and

   (ii) Section 751 (relating to unrealized receivables and inventory items).

   For example, payments under section 736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

   (i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

   (ii) After such contribution the contributed property is distributed to another partner,
such distribution may not fall within the scope of section 731. Section 731
does not apply to a distribution of property, if, in fact, the distribution was
made in order to effect an exchange of property between two or more of the
partners or between the partnership and a partner. Such a transaction shall
be treated as an exchange of property.

Sec. 1.731-2 Partnership distributions of marketable securities.

(a) Marketable securities treated as money.

Except as otherwise provided in section 731(c) and this section, for purposes of
sections 731(a)(1) and 737, the term money includes marketable securities and such
securities are taken into account at their fair market value as of the date of the
distribution.

(b) Reduction of amount treated as money --

(1) Aggregation of securities.

For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable
securities held by a partnership are treated as marketable securities of the same
class and issuer as the distributed security.

(2) Amount of reduction.

The amount of the distribution of marketable securities that is treated as a
distribution of money under section 731(c) and paragraph (a) of this section is
reduced (but not below zero) by the excess, if any, of --

(i) The distributee partner's distributive share of the net gain, if any, which
would be recognized if all the marketable securities held by the partnership
were sold (immediately before the transaction to which the distribution
relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any,
which is attributable to the marketable securities held by the partnership
immediately after the transaction, determined by using the same fair market
value as used under paragraph (b)(2)(i) of this section.

(3) Distributee partner's share of net gain.

For purposes of section 731(c)(3)(B) and paragraph (b)(2) of this section, a
partner's distributive share of net gain is determined --

(i) By taking into account any basis adjustments under section 743(b)
with respect to that partner;

(ii) Without taking into account any special allocations adopted with a
principal purpose of avoiding the effect of section 731(c) and this section;
and

(iii) Without taking into account any gain or loss attributable to a
distributed security to which paragraph (d)(1) of this section applies.
(c) Marketable securities --

(1) In general.

For purposes of section 731(c) and this section, the term marketable securities is defined in section 731(c)(2).

(2) Actively traded.

For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the meaning of section 1092(d)(1). Thus, for example, if XYZ common stock is listed on a national securities exchange, particular shares of XYZ common stock that are distributed by a partnership are marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) Interests in an entity --

(i) Substantially all.

For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) Less than substantially all.

For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) Value of assets.

For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) Exceptions --

(1) In general.

Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if-

(i) The security was contributed to the partnership by the distributee partner;
(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied --

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied --

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) Anti-stuffing rule.

Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) Successor security.

Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and this section otherwise would have applied to the exchanged security.

(e) Investment partnerships --

(1) In general.

Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) Eligible partner --
(i) Contributed services.

For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) Contributed partnership interests.

For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) Trade or business activities.

For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of --

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) Partnership tiers.

For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if --

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.
(f) Basis rules --

(1) Partner's basis --

(i) Partner's basis in distributed securities.

The distributee partner's basis in distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) Partner's basis in partnership interest.

The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) Basis of partnership property.

No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) Coordination with other sections --

(1) Sections 704(c)(1)(B) and 737 --

(i) In general.

If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) Section 704(c)(1)(B).

The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) Section 737 --

(A) Marketable securities as other property.
A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner’s net precontribution gain under section 737(b).

(B) Basis increase under section 737.

The basis of the distributee partner’s interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner’s basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) Section 708(b)(1)(B).

If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) Anti-abuse rule.

The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h) --

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and
(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) Examples.

The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to section 731(c). The examples read as follows:

**Example 1.** Recognition of gain.

(i) A and B form partnership AB as equal partners. A contributes property with a fair market value of $1,000 and an adjusted tax basis of $250. B contributes $1,000 cash. AB subsequently purchases Security X for $500 and immediately distributes the security to A in a current distribution. The basis in A’s interest in the partnership at the time of distribution is $250.

(ii) The distribution of Security X is treated as a distribution of money in an amount equal to the fair market value of Security X on the date of distribution ($500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security X had been sold immediately before the distribution, there would have been no gain recognized by AB and A’s distributive share of the gain would therefore have been zero.) As a result, A recognizes $250 of gain under section 731(a)(1) on the distribution ($500 distribution of money less $250 adjusted tax basis in A's partnership interest).

**Example 2.** Reduction in amount treated as money -- in general.

(i) A and B form partnership AB as equal partners. AB subsequently distributes Security X to A in a current distribution. Immediately before the distribution, AB held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Basis</th>
<th>Gain(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security X</td>
<td>100</td>
<td>70</td>
<td>30</td>
</tr>
<tr>
<td>Security Y</td>
<td>100</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>Security Z</td>
<td>100</td>
<td>110</td>
<td>(10)</td>
</tr>
</tbody>
</table>

(ii) If AB had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized $40 of net gain ($30 gain on Security X plus $20 gain on Security Y minus $10 loss on Security Z). A's distributive share of this gain would have been $20 (one-half of $40 net gain). If AB had sold the remaining securities immediately after the distribution of Security X to
A, the partnership would have $10 of net gain ($20 of gain on Security Y minus $10 loss on Security Z). A’s distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in A’s distributive share of the net gain in AB’s securities ($20 net gain before distribution minus $5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by $15. The distribution of Security X is therefore treated as a distribution of $85 of money to A ($100 fair market value of Security X minus $15 reduction).

Example 3. Reduction in amount treated as money -- carried interest.

(i) A and B form partnership AB. A contributes $1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. B contributes $1,000 in exchange for a 40 percent interest in partnership profits. AB subsequently distributes Security X to A in a current distribution. Immediately before the distribution, AB held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

<table>
<thead>
<tr>
<th>Security</th>
<th>Value</th>
<th>Basis</th>
<th>Gain(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security X</td>
<td>100</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>Security Y</td>
<td>100</td>
<td>90</td>
<td>10</td>
</tr>
</tbody>
</table>

(ii) If AB had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized $30 of net gain ($20 gain on Security X plus $10 gain on Security Y). A’s distributive share of this gain would have been $18 (60 percent of $30 net gain). If AB had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have $10 of net gain ($10 gain on Security Y). A’s distributive share of this gain would have been $6 (60 percent of $10 net gain). As a result, the distribution resulted in a decrease of $12 in A’s distributive share of the net gain in AB’s securities ($18 net gain before distribution minus $6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by $12. The distribution of Security X is therefore treated as a distribution of $88 of money to A ($100 fair market value of Security X minus $12 reduction).

Example 4. Reduction in amount treated as money -- change in partnership allocations.

(i) A is admitted to partnership ABC as a partner with a 1 percent interest in partnership profits. At the time of A’s admission, ABC held no securities. ABC subsequently acquires Security X. A’s interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. A retains a 1 percent interest in all securities acquired before the increase. ABC then acquires Securities Y and Z and later distributes Security X to A in a current distribution. Immediately before the distribution, the securities held by ABC had the following fair market values, adjusted tax bases, and unrecognized gain or loss:
<table>
<thead>
<tr>
<th>Value</th>
<th>Basis</th>
<th>Gain(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security X</td>
<td>1,000</td>
<td>500</td>
</tr>
<tr>
<td>Security Y</td>
<td>1,000</td>
<td>800</td>
</tr>
<tr>
<td>Security Z</td>
<td>1,000</td>
<td>1,100</td>
</tr>
</tbody>
</table>

(ii) If ABC had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized $600 of net gain ($500 gain on Security X plus $200 gain on Security Y minus $100 loss on Security Z). A's distributive share of this gain would have been $7 (1 percent of $500 gain on Security X plus 2 percent of $200 gain on Security Y minus 2 percent of $100 loss on Security Z).

(iii) If ABC had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have $100 of net gain ($200 gain on Security Y minus $100 loss on Security Z). A's distributive share of this gain would have been $2 (2 percent of $200 gain on Security Y minus 2 percent of $100 loss on Security Z). As a result, the distribution resulted in a decrease of $5 in A's distributive share of the net gain in ABC's securities ($7 net gain before distribution minus $2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by $5. The distribution of Security X is therefore treated as a distribution of $995 of money to A ($1000 fair market value of Security X minus $5 reduction).

**Example 5.** Basis consequences -- distributions of marketable security.

(i) A and B form partnership AB as equal partners. A contributes nondepreciable real property with a fair market value and adjusted tax basis of $100.

(ii) AB subsequently distributes Security X with a fair market value of $120 and an adjusted tax basis of $90 to A in a current distribution. At the time of distribution, the basis in A's interest in the partnership is $100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by $15 (one-half of $30 net gain in Security X). As a result, A recognizes $5 of gain under section 731(a) on the distribution (excess of $105 distribution of money over $100 adjusted tax basis in A's partnership interest).

(iii) A's adjusted tax basis in Security X is $95 ($90 adjusted basis of Security X determined under section 732(a)(1) plus $5 of gain recognized by A by reason of section 731(c)). The basis in A's interest in the partnership is $10 as determined under section 733 ($100 pre-distribution basis minus $90 basis allocated to Security X under section 732).

**Example 6.** Basis consequences -- distribution of marketable security and other property.

(i) A and B form partnership AB as equal partners. A contributes nondepreciable real property, with a fair market value of $100 and an adjusted tax basis of $10.

(ii) AB subsequently distributes Security X with a fair market value and adjusted tax basis of $40 to A in a current distribution and, as part of the same distribution, AB
distributes Property Z to A with an adjusted tax basis and fair market value of $40. At the time of distribution, the basis in A's interest in the partnership is $10. A recognizes $30 of gain under section 731(a) on the distribution (excess of $40 distribution of money over $10 adjusted tax basis in A's partnership interest).

(iii) A's adjusted tax basis in Security X is $35 ($5 adjusted basis determined under section 732(a)(2) plus $30 of gain recognized by A by reason of section 731(c)). A's basis in Property Z is $5, as determined under section 732(a)(2). The basis in A's interest in the partnership is $0 as determined under section 733 ($10 pre-distribution basis minus $10 basis allocated between Security X and Property Z under section 732).

(iv) AB's adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If AB made such an election, the aggregate basis of AB's assets would be increased by $70 (the difference between the $80 combined basis of Security X and Property Z in the hands of the partnership before the distribution and the $10 combined basis of the distributed property in the hands of A under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by A by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of A by reason of section 731(c).

Example 7. Coordination with section 737.

(i) A and B form partnership AB. A contributes Property A, nondepreciable real property with a fair market value of $200 and an adjusted basis of $100 in exchange for a 25 percent interest in partnership capital and profits. AB owns marketable Security X.

(ii) Within five years of the contribution of Property A, AB subsequently distributes Security X, with a fair market value of $120 and an adjusted tax basis of $100, to A in a current distribution that is subject to section 737. As part of the same distribution, AB distributes Property Y to A with a fair market value of $20 and an adjusted tax basis of $0. At the time of distribution, there has been no change in the fair market value of Property A or the adjusted tax basis in A's interest in the partnership.

(iii) If AB had sold Security X for fair market value immediately before the distribution to A, the partnership would have recognized $20 of gain. A's distributive share of this gain would have been $5 (25 percent of $20 gain). Because AB has no other marketable securities, A's distributive share of gain in partnership securities after the distribution would have been $0. As a result, the distribution resulted in a decrease of $5 in A's share of the net gain in AB's securities ($5 net gain before distribution minus $0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by $5. The distribution of Security X is therefore treated as a distribution of $115 of money to A ($120 fair market value of Security X minus $5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money ($5) is treated as other property for purposes of section 737.

(iv) A recognizes total gain of $40 on the distribution. A recognizes $15 of gain under section 731(a)(1) on the distribution of the portion of Security X treated as money
($115 distribution of money less $100 adjusted tax basis in A’s partnership interest). A recognizes $25 of gain under section 737 on the distribution of Property Y and the portion of Security X that is not treated as money. A’s section 737 gain is equal to the lesser of (i) A’s precontribution gain ($100) or (ii) the excess of the fair market value of property received ($20 fair market value of Property Y plus $5 portion of Security X not treated as money) over the adjusted basis in A’s interest in the partnership immediately before the distribution ($100) reduced (but not below zero) by the amount of money received in the distribution ($115).

(v) A’s adjusted tax basis in Security X is $115 ($100 basis of Security X determined under section 732(a) plus $15 of gain recognized by reason of section 731(c)). A’s adjusted tax basis in Property Y is $0 under section 732(a). The basis in A’s interest in the partnership is $25 ($100 basis before distribution minus $100 basis allocated to Security X under section 732(a) plus $25 gain recognized under section 737).

(k) Effective date.

This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.


Sec. 1.732-1 Basis of distributed property other than money.

(a) Distributions other than in liquidation of a partner's interest.

The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A’s hands will be $10,000. Under sections 733 and 705, the basis of A’s partnership interest will be reduced by the distribution to $3,000 ($15,000 less $2,000 cash, less $10,000, the basis of the distributed property to A).

Example (2). Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

(b) Distribution in liquidation.
Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

**Example.** Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

(c) ALLOCATION OF BASIS AMONG PROPERTIES DISTRIBUTED TO A PARTNER --

(1) GENERAL RULE --

(i) UNREALIZED RECEIVABLES AND INVENTORY ITEMS.

The basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in paragraph (c)(2)(i) of this section.

(ii) OTHER DISTRIBUTED PROPERTY.

Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in paragraph (c)(2) of this section.

(2) ADJUSTMENT TO BASIS ALLOCATION --

(i) DECREASE IN BASIS.

Any decrease to the basis of distributed property required under paragraph (c)(1) of this section is allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation before any decrease (but only to the extent of each property's unrealized depreciation). If the required decrease exceeds the amount of unrealized depreciation in the distributed property, the excess is allocated to the distributed property in proportion to the adjusted bases of the
distributed property, as adjusted pursuant to the immediately preceding sentence.

(ii) INCREASE IN BASIS.

Any increase to the basis of distributed property required under paragraph (c)(1)(ii) of this section is allocated first to distributed property (other than unrealized receivables and inventory items) with unrealized appreciation in proportion to each property's respective amount of unrealized appreciation before any increase (but only to the extent of each property's unrealized appreciation). If the required increase exceeds the amount of unrealized appreciation in the distributed property, the excess is allocated to the distributed property (other than unrealized receivables or inventory items) in proportion to the fair market value of the distributed property.

(3) UNREALIZED RECEIVABLES AND INVENTORY ITEMS.

If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of the partnership interest.

(4) EXAMPLES.

The provisions of this paragraph (c) are illustrated by the following examples:

EXAMPLE 1. A is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of $650. PRS distributes inventory items and Assets X and Y to A in liquidation of A's entire partnership interest. The distributed inventory items have a basis to the partnership of $100 and a fair market value of $200. Asset X has an adjusted basis to the partnership of $50 and a fair market value of $400. Asset Y has an adjusted basis to the partnership and a fair market value of $100. Neither Asset X nor Asset Y consists of inventory items or unrealized receivables. Under this paragraph (c), A's basis in its partnership interest is allocated first to the inventory items in an amount equal to their adjusted basis to the partnership. A, therefore, has an adjusted basis in the inventory items of $100. The remaining basis, $550, is allocated to the distributed property first in an amount equal to the property's adjusted basis to the partnership. Thus, Asset X is allocated $50 and Asset Y is allocated $100. Asset X is then allocated $350, the amount of unrealized appreciation in Asset X. Finally, the remaining basis, $50, is allocated to Assets X and Y in proportion to their fair market values: $40 to Asset X (400/500 x $50), and $10 to Asset Y (100/500 x $50). Therefore, after the distribution, A has an adjusted basis of $440 in Asset X and $110 in Asset Y.

EXAMPLE 2. B is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of $200. PRS distributes Asset X and Asset Y to B in liquidation of its entire partnership interest. Asset X has an adjusted basis to the partnership and fair market value of $150. Asset Y has an adjusted basis to the partnership of $150 and a fair market value of $50. Neither of the assets consists of inventory items or unrealized receivables. Under this paragraph (c),
B's basis is first assigned to the distributed property to the extent of the partnership's basis in each distributed property. Thus, Asset X and Asset Y are each assigned $150. Because the aggregate adjusted basis of the distributed property, $300, exceeds the basis to be allocated, $200, a decrease of $100 in the basis of the distributed property is required. Assets X and Y have unrealized depreciation of zero and $100, respectively. Thus, the entire decrease is allocated to Asset Y. After the distribution, B has an adjusted basis of $150 in Asset X and $50 in Asset Y.

**EXAMPLE 3.** C, a partner in partnership PRS, receives a distribution in liquidation of its entire partnership interest of $6,000 cash, inventory items having an adjusted basis to the partnership of $6,000, and real property having an adjusted basis to the partnership of $4,000. C's basis in its partnership interest is $9,000. The cash distribution reduces C's basis to $3,000, which is allocated entirely to the inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

**EXAMPLE 4.** Assume the same facts as in EXAMPLE 3 of this paragraph except C receives a distribution in liquidation of its entire partnership interest of $1,000 cash and inventory items having a basis to the partnership of $6,000. The cash distribution reduces C's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to the distributed property, constitutes a capital loss to partner C under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(5) **EFFECTIVE DATE.**

This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(d) **Special partnership basis to transferee under section 732(d).**

(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and sections 1.743-1 and 1.732-2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.
(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the partnership. (For a shift of transferee’s basis adjustment under section 743(b) to like property, see section 1.743-1(g).)

(vi) The provisions of this paragraph (d)(1) may be illustrated by the following example:

Example. The basis to transferee partner K of his one-fourth interest in partnership WJKS is $17,000. At the time he acquired such interest by purchase, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a value of $16,000. K’s purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by K for his one-fourth interest was attributable to his share of partnership inventory with a basis of $3,500. Within 2 years after acquiring his interest, K retired from the partnership and received in liquidation of his entire interest cash of $1,500, inventory with a basis to the partnership of $3,500, property X (a capital asset), with an adjusted basis to the partnership of $2,000, and property Y (a depreciable asset), with an adjusted basis to the partnership of $4,000. The value of the inventory received by K was one-fourth of the value of all partnership inventory and was his share of such property. It is immaterial whether the inventory K received was on hand when K acquired his interest. In accordance with K’s election under section 732(d), the amount of his share of partnership basis which is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the value of such property, $16,000, and its $14,000 basis to the partnership at the time K acquired his interest). This adjustment under section 732(d) applies only for purposes of distributions to partner K, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by K in the liquidating distribution is $15,500 ($17,000, K’s basis for his interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis for such items, plus the special basis adjustment of $500 which K would have had under section 743(b). The remaining basis of $11,500 ($15,500 minus $4,000) is to be allocated to the remaining property distributed to K in proportion to their
adjusted bases to the partnership. Since the adjusted basis to the partnership of property X is $2,000, and that of property Y is $4,000, the $11,500 is allocated $3,833 (2,000/6,000 x $11,500) to X, and $7,667 (4,000/6,000 x $11,500) to Y.

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return:

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest:

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) EXAMPLE.

(i) Transferee partner, T, purchased a one-fourth interest in partnership PRS for $17,000. At the time T purchased the partnership interest, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a fair market value of $16,000. T's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by T for the partnership interest was attributable to T's share of partnership inventory with a basis of $3,500. Within 2 years after T acquired the partnership interest, T retired from the partnership and received in liquidation of its entire partnership interest the following property:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted</th>
<th>Fair</th>
</tr>
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</table>
(ii) The fair market value of the inventory received by T was one-fourth of the fair market value of all partnership inventory and was T's share of such property. It is immaterial whether the inventory T received was on hand when T acquired the interest. In accordance with T's election under section 732(d), the amount of T's share of partnership basis that is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the fair market value of the property, $16,000, and its $14,000 basis to the partnership at the time T purchased its interest). This adjustment under section 732(d) applies only for purposes of distributions to T, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by T in the liquidating distribution is $15,500 ($17,000, T's basis for the partnership interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis, plus the basis adjustment of $500 which T would have had under section 743(b). The remaining basis of $11,500 ($15,500 minus $4,000) is allocated among the remaining property distributed to T by assigning to each property the adjusted basis to the partnership of such property and adjusting that basis by any required increase or decrease. Thus, the adjusted basis to T of Asset X is $5,111 ($2,000, the adjusted basis of Asset X to the partnership, plus $2,000, the amount of unrealized appreciation in Asset X, plus $1,111 ($4,000/$9,000 multiplied by $2,500)). Similarly, the adjusted basis of Asset Y to T is $6,389 ($4,000, the adjusted basis of Asset Y to the partnership, plus $1,000, the amount of unrealized appreciation in Asset Y, plus $1,389 ($5,000/$9,000 multiplied by $2,500)).

(5) REQUIRED STATEMENTS.

If a transferee partner notifies a partnership that it plans to make the election under section 732(d) under paragraph (d)(3) of this section, or if a partnership makes a distribution to which paragraph (d)(4) of this section applies, the partnership must provide the transferee with such information as is necessary for the transferee properly to compute the transferee's basis adjustments under section 732(d).

(e) Exception.

When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially
appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection (d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of section 1.751-1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

Sec. 1.732-2 Special partnership basis of distributed property.

(a) Adjustments under section 734(b).

In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) Adjustments under section 743(b).

In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of $1,000 and with respect to D it has a special basis adjustment of $500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is $1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only $1,000. In such case, D's $500 special basis adjustment may shift over to other property. See section 1.743-1(g).

(c) Adjustments to basis of distributed inventory and unrealized receivables.

Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee
partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

Example. Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743(b). C retires from the partnership when the adjusted basis of his partnership interest is $3,000. He receives from the partnership in liquidation of his entire interest, $1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of $800 with respect to partnership inventory items and of $200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is $500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40 percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be $1,300 for the inventory items ($500 plus $800) and $200 for the unrealized receivables (zero plus $200). The remaining basis of $500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: $3,000 (total basis) less $1,000 cash, or $2,000 (the amount to be allocated to the basis of all distributed property), less $1,500 ($800 and $200 special basis adjustments, plus $500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (i. e., only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of $800 for partnership inventory items and $200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be $650 ($250, the common partnership basis for inventory items distributed to him, plus $400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be $100 (zero plus $100, one-half of C's special basis adjustment for unrealized receivables).

[T.D. 8847, 64 FR 69903-69922, Dec. 15, 1999.]

Sec. 1.733-1 Basis of distributee partner’s interest.
In the case of a distribution by a partnership to a partner other than in liquidation of a partner's entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the amount of the basis to him of distributed property other than money as determined under section 732 and sections 1.732-1 and 1.732-2.

Sec. 1.734-1 Optional adjustment to basis of undistributed partnership property.

(a) General rule.

A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner, unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect.

(b) Method of adjustment--

(1) Increase in basis.

Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by:

(i) The amount of any gain recognized under section 731(a)(1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743(b) or section 732(d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

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

Example (1). Partner A has a basis of $10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. A receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under section 731(a)(1). If the election under section 754 is in effect, the partnership basis for the property becomes $20,000 ($19,000 plus $1,000).

Example (2). Partner D has a basis of $10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 4,000</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Property X</td>
<td>$11,000</td>
<td>$11,000</td>
</tr>
</tbody>
</table>
In liquidation of his entire interest in the partnership, D received property X with a partnership basis of $11,000. D's basis for property X is $10,000 under section 732(b). Where the election under section 754 is in effect, the excess of $1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes $16,000 ($15,000 plus $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see section 1.734-2.

(2) Decrease in basis.

Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by:

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

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

**Example (1).** Partner G has a basis of $11,000 for his one-third interest in partnership GHI. Partnership assets consist of cash of $10,000 and property with a basis of $23,000 and a value of $20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives $10,000 in cash. He has a loss of $1,000 under section 731(a)(2). If the election under section 754 is in effect, the partnership basis for the property becomes $22,000 ($23,000 less $1,000).

**Example (2).** Partner J has a basis of $11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:
Assets                                           Adjusted basis             Value

Cash                      $  5,000             $  5,000
Property X                $10,000             $10,000
Property Y                $18,000             $15,000
Total                     $33,000             $30,000

Liabilities and Capital                                           Adjusted basis             Value

Liabilities               $0                                $0
Capital:
D                        $11,000             $10,000
E                        $11,000             $10,000
F                        $11,000             $10,000
Total                    $33,000             $30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of $10,000. J's basis for property X under section 732(b) is $11,000. Where the election under section 754 is in effect, the excess of $1,000 ($11,000 basis of property X to J, the distributee, less its $10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes $17,000 ($18,000 less $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see section 1.734-2.

(c) Allocation of basis.

For allocation among the partnership properties of basis adjustments under section 734(b) and paragraph (b) of this section, see section 755 and section 1.755-1.

(d) Returns.

A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(e) RECOVERY OF ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY --

(1) INCREASES IN BASIS.

For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-
purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(2) DECREASES IN BASIS.

For purposes of section 168, if the basis of a partnership's recovery property is decreased as a result of the distribution of property to a partner, then the decrease in basis must be accounted for over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.

(3) EFFECTIVE DATE.

This paragraph (e) applies to distributions of property from a partnership that occur on or after December 15, 1999.

[T.D. 8847, 64 FR 69903-69922, Dec. 15, 1999.]

Sec. 1.734-2 Adjustment after distribution to transferee partner.

(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see sections 1.732-1 and 1.732-2.

(b)(1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

Example. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of $4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in
exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751(b) (relating to unrealized receivables and substantially appreciated inventory items). See section 751(b) and paragraph (b) of section 1.751-1.

Sec. 1.735-1 Character of gain or loss on disposition of distributed property.

(a) Sale or exchange of distributed property--

(1) Unrealized receivables.

Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in paragraph (c)(1) of section 1.751-1) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) Inventory items.

Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751(d)(2)) received in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) Holding period for distributed property.

A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership's holding period for contributed property, see section 1.723-1.

(c) Effective date.
Section 735(a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771(b)(2) and paragraph (b)(2) of section 1.771-1. However, see section 771(c).


Sec. 1.736-1 Payments to a retiring partner or a deceased partner’s successor in interest.

(a) Payments considered as distributive share or guaranteed payment.

(1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of Subchapter K, Chapter 1 of the Code, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b)(4)(ii) of section 1.751-1. The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in
assets under the rules contained in paragraph (b) of this section will be considered either:

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(5) The amount of any payments under section 736(a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment. On the other hand, payments under section 736(b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased partner’s successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner’s entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b).

(b) Payments for interest in partnership.

(1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner’s interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner’s interest in partnership property in an arm’s length agreement will be regarded as correct. If such valuation reflects only the partner’s net interest in the property (i.e., total assets less liabilities), it must be adjusted so that both the value of the partner’s interest in property and the basis for his interest take into account the partner’s share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be
recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and paragraph (b) of section 1.751-1. The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see paragraph (b)(3)(iii) of section 1.751-1.

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows:

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a) (1) or (2). However, if the total
amount received in any one year is less than the amount considered as a
distribution under section 736(b) for that year, then any unapplied portion
shall be added to the portion of the payments for the following year or years
which are to be treated as a distribution under section 736(b). For example,
retiring partner W who is entitled to an annual payment of $6,000 for 10
years for his interest in partnership property, receives only $3,500 in 1955. In
1956, he receives $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from
1955) is treated as a distribution under section 736 (b) for 1956; $1,500, as a
payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest
receives payments which are not fixed in amount, such payments shall first
be treated as payments in exchange for his interest in partnership property
under section 736(b) to the extent of the value of that interest and, thereafter,
as payments under section 736(a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this
subparagraph, the allocation of each annual payment between section 736
(a) and (b) may be made in any manner to which all the remaining partners
and the withdrawing partner or his successor in interest agree, provided that
the total amount allocated to property under section 736(b) does not exceed
the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or
loss with respect to payments under section 736(b) for a retiring or deceased
partner's interest in property for each year of payment shall be determined under
section 731. However, where the total of section 736(b) payments is a fixed sum,
a retiring partner or a deceased partner's successor in interest may elect (in his
tax return for the first taxable year for which he receives such payments), to
report and to measure the amount of any gain or loss by the difference between:

(i) The amount treated as a distribution under section 736(b) in that year,
and

(ii) The portion of the adjusted basis of the partner for his partnership
interest attributable to such distribution (i.e., the amount which bears the
same proportion to the partner’s total adjusted basis for his partnership
interest as the amount distributed under section 736(b) in that year bears to
the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement
to his tax return for the first taxable year for which he receives such
payments, indicating his election and showing the computation of the gain
included in gross income.

(7) The provisions of this paragraph may be illustrated by the following
examples:

Example (1). Partnership ABC is a personal service partnership and its balance
sheet is as follows:
Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.
Example (2). Assume the same facts as in example (1) of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

Example (3). Assume the same facts as in example (1) of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be $9,000. The value of A's interest in partnership property described in section 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and section 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000, minus $11,000) the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

Example (4). Assume the same facts as in example (1) of this subparagraph except that the capital and section 1231 assets consist of an item of section 1245 property (as defined in section 1245(a)(3)). Assume further that under paragraph (c)(4) of section 1.751-1 the section 1245 property is an unrealized receivable to the extent of $2,000. Therefore, the value of A's interest in section 736(b) partnership property is only $11,333 (one-third of $34,000, the sum of $13,000 cash and $21,000, the fair market value of section 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of $333 ($11,333 minus $11,000, the basis of his interest). The remaining $18,667 ($30,000 minus $11,333) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) Cross reference.

See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.


Sec. 1.737-1 Recognition of precontribution gain.

(b) Excess distribution --
(1) DEFINITION.

The excess distribution is the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in the partner's partnership interest.

(2) FAIR MARKET VALUE OF PROPERTY.

The fair market value of the distributed property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(3) DISTRIBUTEE PARTNER'S ADJUSTED TAX BASIS --

(i) GENERAL RULE.

In determining the amount of the excess distribution, the distributee partner's adjusted tax basis in the partnership interest includes any basis adjustment resulting from the distribution that is subject to section 737 (for example, adjustments required under section 752) and from any other distribution or transaction that is part of the same distribution, except for --

(A) The increase required under section 737(c)(1) for the gain recognized by the partner under section 737; and

(B) The decrease required under section 733(2) for any property distributed to the partner other than property previously contributed to the partnership by the distributee partner. See section 1.704- 4(e)(1) for a rule in the context of section 704(c)(1)(B). See also section 1.737-3(b)(2) for a special rule for determining a partner's adjusted tax basis in distributed property previously contributed by the partner to the partnership.

(ii) ADVANCES OR DRAWINGS.

The distributee partner's adjusted tax basis in the partnership interest is determined as of the last day of the partnership's taxable year if the distribution to which section 737 applies is properly characterized as an advance or drawing against the partner's distributive share of income. See section 1.731-1(a)(1)(ii).

(c) Net precontribution gain --

(1) GENERAL RULE.

The distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) and section 1.704-4 if all property that had been contributed to the partnership by the distributee partner within five years of the distribution and is
held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. See section 1.704-4 for provisions determining a contributing partner's gain or loss under section 704(c)(1)(B) on an actual distribution of contributed section 704(c) property to another partner.

(2) SPECIAL RULES --

(i) PROPERTY CONTRIBUTED ON OR BEFORE OCTOBER 3, 1989.

Property contributed to the partnership on or before October 3, 1989, is not taken into account in determining a partner's net precontribution gain. See section 1.704-4(c)(1) for a similar rule in the context of section 704(c)(1)(B).

(ii) SECTION 734(b)(1)(A) ADJUSTMENTS.

For distributions to a distributee partner of money by a partnership with a section 754 election in effect that are part of the same distribution as the distribution of property subject to section 737, for purposes of paragraph (a) and (c)(1) of this section the distributee partner's net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). See section 1.737-3(c)(4) for rules regarding basis adjustments for partnerships with a section 754 election in effect.

(iii) TRANSFERS OF A PARTNERSHIP INTEREST.

The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred. See section 1.704-3(a)(7) and section 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

(iv) SECTION 704(c)(1)(B) GAIN RECOGNIZED IN RELATED DISTRIBUTION.

A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and section 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and section 1.704-4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

(v) SECTION 704(c)(2) DISREGARDED.

A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and section 1.704-4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.
(d) Character of gain.

The character of the gain recognized by the distributee partner under section 737 and this section is determined by, and is proportionate to, the character of the partner's net precontribution gain. For this purpose, all gains and losses on section 704(c) property taken into account in determining the partner's net precontribution gain are netted according to their character. Character is determined at the partnership level for this purpose, and any character with a net negative amount is disregarded. The character of the partner's gain under section 737 is the same as, and in proportion to, any character with a net positive amount. Character for this purpose is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and section 1.702-1(a).

(e) Examples.

The following examples illustrate the provisions of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

EXAMPLE 1. CALCULATION OF EXCESS DISTRIBUTION AND NET PRECONTRIBUTION GAIN.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable real property with a fair market value of $30,000 and an adjusted tax basis of $20,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $30,000. C contributes $30,000 cash.

(ii) Property A has 10 years remaining on its cost recovery schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items under section 704(c) described in section 1.704-3(b)(1) for Property A. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis in Property A) and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership also has tax depreciation of $2,000 per year (10 percent of the $20,000 adjusted tax basis in Property A). This $2,000 tax depreciation is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of 1997, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and its adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation).

(iv) On December 31, 1997, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is $20,000. The amount of the excess distribution is $10,000, the difference between the fair market value of the distributed Property B ($30,000) and A's
adjusted tax basis in A's partnership interest ($20,000). A's net precontribution gain is $7,000, the difference between the book value of Property A ($21,000) and its adjusted tax basis at the time of the distribution ($14,000). A recognizes gain of $7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

EXAMPLE 2. DETERMINATION OF DISTRIBUTEE PARTNER'S BASIS.

(i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C each contributes $10,000 cash.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of $9,000, subject to a $9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under section 752, increasing A's adjusted tax basis in A's partnership interest from $4,000 to $7,000.

(iii) On December 31, 1998, A receives $2,000 cash and Property B, subject to the $9,000 liability, in a current distribution.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A's partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A's adjusted tax basis is therefore increased to $11,000 for this purpose ($7,000 initial adjusted tax basis, less $2,000 distribution of money, less $3,000 (decrease in A's share of the $9,000 partnership liability), plus $9,000 (increase in A's individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A's partnership interest ($11,000) is greater than the fair market value of the distributed property ($9,000) and therefore, there is no excess distribution. A recognizes no gain under section 737.

EXAMPLE 3. NET PRECONTRIBUTION GAIN REDUCED FOR GAIN RECOGNIZED UNDER SECTION 704(c)(1)(B).

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Properties A1 and A2, nondepreciable real properties located in the United States each with a fair market value of $10,000 and an adjusted tax basis of $6,000. B contributes Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of $20,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest and, as part of the same distribution, Property A1 is distributed to B in a current distribution.

(iii) A's net precontribution gain before the distribution is $8,000 ($20,000 fair market value of Properties A1 and A2 less $12,000 adjusted tax basis of such properties). A recognizes $4,000 of gain under section 704(c)(1)(B) and section 1.704-4 on the distribution of Property A1 to B ($10,000 fair market value of Property A1 less $6,000 adjusted tax basis of Property A1). This gain is taken into account in determining A's excess distribution and net precontribution gain. As a result, A's net precontribution gain is reduced from $8,000 to $4,000, and the adjusted tax basis in A's partnership interest is increased by $4,000 to $16,000.
(iv) A recognizes gain of $4,000 on the receipt of Property B under section 737, an amount equal to the lesser of the excess distribution of $4,000 ($20,000 fair market value of Property B less $16,000 adjusted tax basis of A's interest in the partnership) and A's remaining net precontribution gain of $4,000.

EXAMPLE 4. CHARACTER OF GAIN.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

<table>
<thead>
<tr>
<th>Property</th>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>$30,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>A2</td>
<td>$30,000</td>
<td>$38,000</td>
</tr>
<tr>
<td>A3</td>
<td>$10,000</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $70,000. C contributes $70,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes $3,000 of gain under section 737, an amount equal to the excess distribution of $3,000 ($70,000 fair market value of Property B less $67,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $3,000 ($70,000 aggregate fair market value of properties contributed by A less $67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A's gain, all gains and losses on property taken into account in determining A's net precontribution gain are netted according to their character and allocated to A's recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains into account separately under section 702. As a result, A's net precontribution gain of $3,000 consists of $2,000 of net long-term, U.S.-source capital gain ($10,000 gain on Property A1 and $8,000 loss on Property A2) and $1,000 of net long-term, foreign-source capital gain ($1,000 gain on Property A3).

(v) The character of A's gain under paragraph (d) of this section is therefore $2,000 long-term, U.S.-source capital gain ($3,000 gain recognized under section 737 x $2,000 net long-term, U.S.-source capital gain/$3,000 total net precontribution gain) and $1,000 long-term, foreign-source capital gain ($3,000 gain recognized under section 737 x $1,000 net long-term, foreign-source capital gain/$3,000 total net precontribution gain).


Sec. 1.737-2 Exceptions and special rules.

(a) Section 708(b)(1)(B) terminations.
Section 737 and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner of the terminated partnership is subject to section 737 to the same extent that a distribution from the terminated partnership would have been subject to section 737. See also section 1.704-4(c)(3) for a similar rule in the context of section 704(c)(1)(B). This paragraph (a) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a) to the termination in a consistent manner.

(b) Transfers to another partnership --

(1) COMPLETE TRANSFER.

Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. See section 1.704-4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

(2) CERTAIN DIVISIVE TRANSACTIONS.

Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership.

(3) SUBSEQUENT DISTRIBUTIONS.

A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

(c) Incorporation of a partnership.

Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See section 1.704-4(c)(5) for a similar rule in the context of section 704(c)(1)(B).

(d) Distribution of previously contributed property --

(1) GENERAL RULE.
Any portion of the distributed property that consists of property previously contributed by the distributee partner (previously contributed property) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. The previous sentence applies on or after May 9, 1997. See section 1.737-3(b)(2) for a special rule for determining the basis of previously contributed property in the hands of a distributee partner who contributed the property to the partnership.

(2) LIMITATION FOR DISTRIBUTION OF PREVIOUSLY CONTRIBUTED INTEREST IN AN ENTITY.

An interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership. The preceding sentence does not apply to the extent that the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership.

(3) NONRECOGNITION TRANSACTIONS.

Property received by the partnership in exchange for contributed section 704(c) property in a nonrecognition transaction is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the property received is treated as section 704(c) property under section 1.704-3(a)(8). See section 1.704- 4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(4) UNDIVIDED INTERESTS.

The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See section 1.704-4(c)(6) for the application of section 704(c)(1)(B) in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(e) Examples.

The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

EXAMPLE 1. Distribution of previously contributed property.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:
### Example 1:

<table>
<thead>
<tr>
<th>Property</th>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>$20,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>A2</td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

(ii) A’s total net precontribution gain on the contributed property is $14,000 ($10,000 on Property A1 plus $4,000 on Property A2). B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $20,000. C contributes $30,000 cash.

(iii) On December 31, 1998, Property A2 and Property B are distributed to A in complete liquidation of A’s interest in the partnership. Property A2 was previously contributed by A and is therefore not taken into account in determining the amount of the excess distribution or A’s net precontribution gain. The adjusted tax basis of Property A2 in the hands of A is also determined under section 732 as if that property were the only property distributed to A.

(iv) As a result of excluding Property A2 from these determinations, the amount of the excess distribution is $10,000 ($20,000 fair market value of distributed Property B less $10,000 adjusted tax basis in A’s partnership interest). A’s net precontribution gain is also $10,000 ($14,000 total net precontribution gain less $4,000 gain with respect to previously contributed Property A2). A therefore recognizes $10,000 of gain on the distribution, the lesser of the excess distribution and the net precontribution gain.

### Example 2: Distribution of a Previously Contributed Interest in an Entity.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000, and all of the stock of Corporation X with a fair market value and adjusted tax basis of $500. B contributes $500 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. Partner C contributes $10,500 cash. On December 31, 1996, ABC contributes Property B to Corporation X in a nonrecognition transaction under section 351.

(ii) On December 31, 1998, all of the stock of Corporation X is distributed to A in complete liquidation of A’s interest in the partnership. The stock is treated as previously contributed property with respect to A only to the extent of the $500 fair market value of the Corporation X stock contributed by A. The fair market value of the distributed stock for purposes of determining the amount of the excess distribution is therefore $10,000 ($10,500 total fair market value of Corporation X stock less $500 portion treated as previously contributed property). The $500 fair market value and adjusted tax basis of the Corporation X stock is also not taken into account in determining the amount of the excess distribution and the net precontribution gain.

(iii) A recognizes $5,000 of gain under section 737, the amount of the excess distribution ($10,000 fair market value of distributed property less $5,000 adjusted tax basis in A’s partnership interest) and A’s net precontribution gain ($10,000 fair market value of Property A less $5,000 adjusted tax basis in Property A).
EXAMPLE 3. DISTRIBUTION OF UNDIVIDED INTEREST IN PROPERTY.

(i) On January 1, 1995, A and B form partnership AB as equal partners. A contributes $500 cash and an undivided one-half interest in Property X. B contributes $500 cash and an undivided one-half interest in Property X.

(ii) On December 31, 1998, an undivided one-half interest in Property X is distributed to A in a current distribution. The distribution of the undivided one-half interest in Property X is treated as a distribution of previously contributed property because A contributed an undivided one-half interest in Property X. As a result, A does not recognize any gain under section 737 on the distribution.


Sec. 1.737-3 Basis adjustments; Recovery rules.

(a) DISTRIBUTEE PARTNER'S ADJUSTED TAX BASIS IN THE PARTNERSHIP INTEREST.

The distributee partner's adjusted tax basis in the partnership interest is increased by the amount of gain recognized by the distributee partner under section 737 and this section. This increase is not taken into account in determining the amount of gain recognized by the partner under section 737(a)(1) and this section or in determining the amount of gain recognized by the partner under section 731(a) on the distribution of money in the same distribution or any related distribution. See section 1.704-4(e)(1) for a determination of the distributee partner's adjusted tax basis in a distribution subject to section 704(c)(1)(B).

(b) DISTRIBUTEE PARTNER'S ADJUSTED TAX BASIS IN DISTRIBUTED PROPERTY --

(1) IN GENERAL.

The distributee partner's adjusted tax basis in the distributed property is determined under section 732(a) or (b) as applicable. The increase in the distributee partner's adjusted tax basis in the partnership interest under paragraph (a) of this section is taken into account in determining the distributee partner's adjusted tax basis in the distributed property other than property previously contributed by the partner. See section 1.704-4(e)(2) for a determination of basis in a distribution subject to section 704(c)(1)(B).

(2) PREVIOUSLY CONTRIBUTED PROPERTY.

The distributee partner's adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to section 737 and section 1.737-1.

(c) PARTNERSHIP'S ADJUSTED TAX BASIS IN PARTNERSHIP PROPERTY--

(1) INCREASE IN BASIS.
The partnership's adjusted tax basis in eligible property is increased by the amount of gain recognized by the distributee partner under section 737.

(2) ELIGIBLE PROPERTY.

Eligible property is property that--

(i) Entered into the calculation of the distributee partner's net precontribution gain;

(ii) Has an adjusted tax basis to the partnership less than the property's fair market value at the time of the distribution;

(iii) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(iv) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) and section 1.704-4 that was part of the same distribution as the distribution subject to section 737.

(3) METHOD OF ADJUSTMENT.

For the purpose of allocating the basis increase under paragraph (c)(2) of this section among the eligible property, all eligible property of the same character is treated as a single group. Character for this purpose is determined in the same manner as the character of the recognized gain is determined under section 1.737-1(d). The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under section 737. The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property's fair market value and its adjusted tax basis to the partnership at the time of the distribution. For property that has the same character and was contributed in the same (or a related) transaction, the basis increase is allocated based on the respective amounts of unrealized appreciation in such properties at the time of the distribution.

(4) SECTION 754 ADJUSTMENTS.

The basis adjustments to partnership property made pursuant to paragraph (c)(1) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including eligible property as defined in paragraph (c)(2) of this section) under section 734(b) pursuant to a section 754 election (other than basis adjustments under section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments to basis made under paragraph (a) and paragraph (c)(1) of this section. Basis adjustments under section 734(b)(1)(A) that are attributable to distributions of money to the distributee partner that are part of the same distribution as the distribution of property subject to section 737 are made before the adjustments to basis under paragraph (a) and paragraph (c)(1) of this section. See section 1.737-1(c)(2)(ii) for the effect, if any, of basis adjustments
under section 734(b)(1)(A) on a partner’s net precontribution gain. See also section 1.704-4(e)(3) for a similar rule regarding basis adjustments pursuant to a section 754 election in the context of section 704(c)(1)(B).

(d) RECOVERY OF INCREASE TO ADJUSTED TAX BASIS.

Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) EXAMPLES.

The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

EXAMPLE 1. PARTNER'S BASIS IN DISTRIBUTED PROPERTY.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $10,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A’s interest in the partnership. A recognizes $5,000 of gain under section 737, an amount equal to the excess distribution of $5,000 ($10,000 fair market value of Property B less $5,000 adjusted tax basis in A’s partnership interest) and A’s net precontribution gain of $5,000 ($10,000 fair market value of Property A less $5,000 adjusted tax basis of such property).

(iii) A’s adjusted tax basis in A’s partnership interest is increased by the $5,000 of gain recognized under section 737. This increase is taken into account in determining A’s basis in the distributed property. Therefore, A’s adjusted tax basis in distributed Property B is $10,000 under section 732(b).

EXAMPLE 2. PARTNER'S BASIS IN DISTRIBUTED PROPERTY IN CONNECTION WITH GAIN RECOGNIZED UNDER SECTION 704(c)(1)(B).

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property located in the United States to the partnership:

<table>
<thead>
<tr>
<th>Property</th>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A1</td>
<td>$10,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Property A2</td>
<td>$10,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>
(ii) B contributes $10,000 cash and Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in a current distribution and Property A1 is distributed to B in a current distribution. A recognizes $5,000 of gain under section 704(c)(1)(B) and section 1.704-4 on the distribution of Property A1 to B, the difference between the fair market value of such property ($10,000) and the adjusted tax basis in distributed Property A1 ($5,000). The adjusted tax basis of A's partnership interest is increased by this $5,000 of gain under section 704(c)(1)(B) and section 1.704-4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the excess distribution. As a result, there is no excess distribution because the fair market value of Property B ($10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution ($12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is $10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from $12,000 to $2,000 under section 733. See Example 3 of section 1.737-1(e).

**EXAMPLE 3. PARTNERSHIP'S BASIS IN PARTNERSHIP PROPERTY AFTER A DISTRIBUTION WITH SECTION 737 GAIN.**

(i) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

<table>
<thead>
<tr>
<th>Property</th>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A1</td>
<td>$1,000</td>
<td>$500</td>
</tr>
<tr>
<td>Property A2</td>
<td>$4,000</td>
<td>$1,500</td>
</tr>
<tr>
<td>Property A3</td>
<td>$4,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Property A4</td>
<td>$6,000</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $15,000. C contributes $15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of $3,000 under section 737, an amount equal to the excess distribution of $3,000 ($15,000 fair market value of Property B less $12,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $3,000 ($15,000 aggregate fair market value of the property contributed by A less $12,000 aggregate adjusted tax basis of such property).

(iv) $2,000 of A's gain is long-term, foreign-source capital gain ($3,000 total gain under section 737 x $2,000 net long-term, foreign-source capital gain/$3,000 total net precontribution gain). $1,000 of A's gain is long-term, U.S.-source capital gain
($3,000 total gain under section 737 x $1,000 net long-term, U.S.-source capital gain/$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by $3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) $2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because $2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from $4,000 to $6,000. $1,000 of the increase must be allocated to Properties A1 and A2 because $1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The $1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by $167 ($1,000 x $500/$3,000) and the adjusted tax basis of Property A2 is increased by $833 ($1,000 x $2,500/3,000).


**Sec. 1.737-4 Anti-abuse rule.**

(a) IN GENERAL.

The rules of section 737 and sections 1.737-1, 1.737-2, and 1.737-3 must be applied in a manner consistent with the purpose of section 737. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See section 1.704-4(f) for an anti-abuse rule and examples in the context of section 704(c)(1)(B). The anti-abuse rule and examples under section 704(c)(1)(B) and section 1.704-4(f) are relevant to section 737 and sections 1.737-1, 1.737-2, and 1.737-3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) EXAMPLES.

The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.
EXAMPLE 1. INCREASE IN DISTRIBUTEE PARTNER'S BASIS BY TEMPORARY CONTRIBUTION; RESULTS INCONSISTENT WITH THE PURPOSE OF SECTION 737.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B contributes Property B, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $10,000. C contributes $10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of $9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from $1,000 to $10,000. On January 1, 1999, the partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B ($10,000) does not exceed the adjusted tax basis of A's interest in the partnership ($10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is $10,000 under section 732(a)(1) and the adjusted tax basis of A's partnership interest is reduced to zero under section 733.

(iii) On March 1, 2000, A receives Property A2 from the partnership in complete liquidation of A's interest in the partnership. A recognizes no gain on the distribution of Property A2 because the property was previously contributed property. See section 1.737-2(d).

(iv) Although A has treated the transfer of Property A2 as a contribution to the partnership that increased the adjusted tax basis of A's interest in the partnership, it would be inconsistent with the purpose of section 737 to recognize the transfer as a contribution to the partnership. Section 737 requires recognition of gain when the value of distributed property exceeds the distributed partner's adjusted tax basis in the partnership interest. Section 737 assumes that any contribution or other transaction that affects a partner's adjusted tax basis in the partnership interest is a contribution or transaction in substance and is not engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the transfer of Property A2 to the partnership was not a contribution in substance and was made with a principal purpose of avoiding recognition of gain under section 737, the Commissioner can disregard the contribution of Property A2 for this purpose. As a result, A recognizes gain of $9,000 under section 737 on the receipt of Property B, an amount equal to the lesser of the excess distribution of $9,000 ($10,000 fair market value of distributed Property B less the $1,000 adjusted tax basis of A's partnership interest, determined without regard to the transitory contribution of Property A2) or A's net precontribution gain of $9,000 on Property A1.

EXAMPLE 2. INCREASE IN DISTRIBUTEE PARTNER'S BASIS; SECTION 752 LIABILITY SHIFT; RESULTS CONSISTENT WITH THE PURPOSE OF SECTION 737.
(i) On January 1, 1995, A and B form general partnership AB as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. The partnership also borrows $10,000 on a recourse basis and purchases Property C. The $10,000 liability is allocated equally between A and B under section 752, thereby increasing the adjusted tax basis in A's partnership interest to $6,000.

(ii) On December 31, 1998, the partners agree that A is to receive Property B in a current distribution. If A were to receive Property B at that time, A would recognize $4,000 of gain under section 737, an amount equal to the lesser of the excess distribution of $4,000 ($10,000 fair market value of Property B less $6,000 adjusted tax basis in A's partnership interest) or A's net precontribution gain of $9,000 ($10,000 fair market value of Property A less $1,000 adjusted tax basis of Property A).

(iii) With a principal purpose of avoiding such gain, A and B agree that A will be solely liable for the repayment of the $10,000 partnership liability and take the steps necessary so that the entire amount of the liability is allocated to A under section 752. The adjusted tax basis in A's partnership interest is thereby increased from $6,000 to $11,000 to reflect A's share of the $5,000 of liability previously allocated to B. As a result of this increase in A's adjusted tax basis, there is no excess distribution because the fair market value of distributed Property B ($10,000) is less than the adjusted tax basis of A's partnership interest. Recognizing A's increased adjusted tax basis as a result of the shift in liabilities is consistent with the purpose of section 737 and this section. Section 737 requires recognition of gain only when the value of the distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. The $10,000 recourse liability is a bona fide liability of the partnership that was undertaken for a substantial business purpose and A's and B's agreement that A will assume responsibility for repayment of that debt has substance. Therefore, the increase in A's adjusted tax basis in A's interest in the partnership due to the shift in partnership liabilities under section 752 is respected, and A recognizes no gain under section 737.


Sec. 1.737-5 Effective date.

Sections 1.737-1, 1.737-2, 1.737-3, and 1.737-4 apply to distributions by a partnership to a partner on or after January 9, 1995.


Sec. 1.741-1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under
section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and section 1.751-1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708(b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

(d) For rules relating to the treatment of liabilities on the sale or exchange of interests in a partnership see sections 1.752-1 and 1.1001-2.


Sec. 1.742-1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by Part II (section 1011 and following), Subchapter O, Chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of section 1.706-1 and paragraph (b) of section 1.753-1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

Sec. 1.751-1 Unrealized receivables and inventory items.

(a) Sale or exchange of interest in a partnership--

(1) Character of amount realized.
To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated substantially in value", see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) DETERMINATION OF GAIN OR LOSS.

The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under section 1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest.

(3) STATEMENT REQUIRED.

A partner selling or exchanging any part of an interest in a partnership that has any section 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information --

(i) The date of the sale or exchange;

(ii) The amount of any gain or loss attributable to the section 751 property; and

(iii) The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

(b) Certain distributions treated as sales or exchanges--

(1) In general.

(i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies
whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30 percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).

(i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the
partners’ distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee’s adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) Distribution of partnership property other than section 751 property.

(i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner’s income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner’s adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).
(4) Exceptions.

(i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property or substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and section 1.736-1.

(5) Statement required.

A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) Unrealized receivables.

(1) The term "unrealized receivables", as used in Subchapter K, Chapter 1 of the Code, means any rights (contractual or otherwise) to payment for:

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

...
the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)(i) With respect to any taxable year of a partnership ending after September 12, 1966 (but only in respect of expenditures paid or incurred after that date), the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from mining property defined in section 617(f)(2). With respect to each item of partnership mining property so defined, the potential gain is the amount that would be treated as gain to which section 617(d)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(ii) With respect to sales, exchanges, or other dispositions after December 31, 1975, in any taxable year of a partnership ending after that date, the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in a DISC as described in section 992(a). With respect to stock in such a DISC, the potential gain is the amount that would be treated as gain to which section 995(c) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(iii) With respect to any taxable year of a partnership beginning after December 31, 1962, the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1245 property. With respect to each item of partnership section 1245 property (as defined in section 1245(a)(3)), potential gain from section 1245 property is the amount that would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See section 1.1245-1(e)(1). For example, if a partnership would recognize under section 1245(a)(1) gain of $600 upon a sale of one item of section 1245 property and gain of $300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be $900.
(iv) With respect to transfers after October 9, 1975, and to sales, exchanges, and distributions taking place after that date, the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in certain foreign corporations as described in section 1248. With respect to stock in such a foreign corporation, the potential gain is the amount that would be treated as gain to which section 1248(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(v) With respect to any taxable year of a partnership ending after December 31, 1963, the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1250 property. With respect to each item of partnership section 1250 property (as defined in section 1250(c)), potential gain from section 1250 property is the amount that would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partnership at its fair market value. See section 1.1250-1(f)(1).

(vi) With respect to any taxable year of a partnership beginning after December 31, 1969, the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm recapture property as defined in section 1251(e)(1) (as in effect before enactment of the Tax Reform Act of 1984). With respect to each item of partnership farm recapture property so defined, the potential gain is the amount which would be treated as gain to which section 1251(c) (as in effect before enactment of the Tax Reform Act of 1984) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(vii) With respect to any taxable year of a partnership beginning after December 31, 1969, the term UNREALIZED RECEIVABLES, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm land as defined in section 1252(a)(2). With respect to each item of partnership farm land so defined, the potential gain is the amount that would be treated as gain to which section 1252(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(viii) With respect to transactions which occur after December 31, 1976, in any taxable year of a partnership ending after that date, the term unrealized receivables, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from franchises, trademarks, or trade names referred to in section 1253(a). With respect to each such item so referred to in section 1253(a), the potential gain is the amount that would be treated as gain to which section 1253 (a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the items were sold by the partnership at its fair market value.
(ix) With respect to any taxable year of a partnership ending after December 31, 1975, the term unrealized receivables, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain under section 1254(a) from natural resource recapture property as defined in section 1.1254-1(b)(2). With respect to each separate partnership natural resource recapture property so described, the potential gain is the amount that would be treated as gain to which section 1254(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the property were sold by the partnership at its fair market value.

(5) For purposes of subtitle A of the Internal Revenue Code, the basis of any potential gain described in paragraph (c)(4) of this section is zero.

(6)(i) If (at the time of any transaction referred to in paragraph (c)(4) of this section) a partnership holds property described in paragraph (c)(4) of this section and if --

(A) A partner had a special basis adjustment under section 743(b) in respect of the property;

(B) The basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d); or

(C) On the date a partner acquired a partnership interest by way of a sale or exchange (or upon the death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, the partner's share of any potential gain described in paragraph (c)(4) of this section is determined under paragraph (c)(6)(ii) of this section.

(ii) The partner's share of the potential gain described in paragraph (c)(4) of this section in respect of the property to which this paragraph (c)(6)(ii) applies is that amount of gain that the partner would recognize under section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c) (as in effect before the Tax Reform Act of 1984), 1252(a), 1253(a), or 1254(a) (as the case may be) upon a sale of the property by the partnership, except that, for purposes of this paragraph (c)(6) the partner's share of such gain is determined in a manner that is consistent with the manner in which the partner's share of partnership property is determined; and the amount of a potential special basis adjustment under section 732(d) is treated as if it were the amount of a special basis adjustment under section 743(b). For example, in determining, for purposes of this paragraph (c)(6), the amount of gain that a partner would recognize under section 1245 upon a sale of partnership property, the items allocated under section 1.1245-1(e)(3)(ii) are allocated to the partner in the same manner as the partner's share of partnership property is determined. See section 1.1250-1(f) for rules similar to those contained in section 1.1245-1(e)(3)(iii).

(d) Inventory items which have substantially appreciated in value--

(1) Substantial appreciation.
Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms "inventory items which have appreciated substantially in value" or "substantially appreciated inventory items" refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the "fair market value" of inventory items has the same meaning as "market" value in the regulations under section 471, relating to general rule for inventories.

(2) Inventory items.

The term "inventory items" as used in Subchapter K, Chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivision (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) Section 751 property and other property.

For the purposes of this section, "section 751 property" means unrealized receivables or substantially appreciated inventory items, and "other property" means all property (including money) except section 751 property.
(f) Effective date.

Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of Subchapter K, Chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of section 1.771-1. See also section 771(c) and paragraph (c) of section 1.771-1. The rules contained in paragraphs (a)(2) and (a)(3) of this section apply to transfers of partnership interests that occur on or after December 15, 1999.

(g) Examples.

Application of the provisions of section 751 may be illustrated by the following examples:

EXAMPLE 1. (i)(A) A and B are equal partners in personal service partnership PRS. B transfers its interest in PRS to T for $15,000 when PRS’s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Loans receivable</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital Assets</td>
<td>$7,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Unrealized receivables</td>
<td>$0</td>
<td>$14,000</td>
</tr>
<tr>
<td>Total</td>
<td>$20,000</td>
<td>$32,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>Per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$9,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>B</td>
<td>$9,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total</td>
<td>$20,000</td>
<td>$32,000</td>
</tr>
</tbody>
</table>

(B) None of the assets owned by PRS is section 704(c) property, and the capital assets are nondepreciable. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B’s share of the partnership liabilities assumed by T. See section 752. B’s undivided half-interest in the partnership property includes a half-interest in the partnership’s unrealized receivables items. B’s basis for its partnership interest is $10,000 ($9,000, plus $1,000, B’s share of partnership liabilities). If section 751(a) did not apply to the sale, B would
recognize $6,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(ii) If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($6,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($7,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $1,000 capital loss.

Example (2). (a) Facts. Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis</th>
<th>Value</th>
<th>Fair Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$9,000</td>
<td>$9,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>$21,000</td>
<td>$30,000</td>
<td></td>
</tr>
<tr>
<td>Depreciable property</td>
<td>$42,000</td>
<td>$48,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$9,000</td>
<td>$9,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$96,000</td>
<td>$111,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>Per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td>$21,000</td>
<td>$21,000</td>
</tr>
<tr>
<td><strong>Capital:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>B</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>C</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$96,000</td>
<td>$111,000</td>
</tr>
</tbody>
</table>

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) Presence of section 751 property. The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $96,000 or
$9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000 in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable property ($1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus, $13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

1) The section 751(b) sale or exchange. C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:
The section 751(b) sale or exchange. The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C’s share of liabilities), $13,000 was paid to acquire C’s interest in inventory ($10,000 fair market value) and in accounts receivable ($3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C’s share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C’s share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C’s share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of section 1.732-1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C’s interest in the inventory and accounts receivable, it gave up money and assumed C’s share of liabilities.

The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not in exchange for C’s interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C’s hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner’s partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner’s original share of the liabilities, plus $6,000, the share of C’s liabilities each assumed).

Partnership trial balance. A trial balance of the AB partnership after the distribution in liquidation of C’s entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an
election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

Example (3). (a) Facts. Assume that the distribution to partner C in example (2) of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

<table>
<thead>
<tr>
<th></th>
<th>Sec. 754, Election in effect</th>
<th></th>
<th>Sec. 754, Election not in effect</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basis</td>
<td>FMV</td>
<td>Basis</td>
<td>FMV</td>
</tr>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Accounts</td>
<td>$9,000</td>
<td>$9,000</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>receivable Inventory</td>
<td>$24,000</td>
<td>$30,000</td>
<td>$24,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Depreciable</td>
<td>$29,000</td>
<td>$33,000</td>
<td>$27,000</td>
<td>$33,000</td>
</tr>
<tr>
<td>property</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$9,000</td>
<td>$9,000</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$76,000</td>
<td>$86,000</td>
<td>$74,000</td>
<td>$86,000</td>
</tr>
</tbody>
</table>

(b) Presence of section 751 property. For the same reason as stated in paragraph (b) of example (2), the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of C's share was received by him in exchange for $7,000 of depreciable property.

(d) Distributee partner's tax consequences. C's tax consequence on the distributions are as follows:
(1) The section 751(b) sale or exchange. C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example (4). (a) Facts. Assume the same facts as in example (3) of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the $7,000 of inventory which he received in excess of his share.
(b) Presence of section 751 property. For the same reasons stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. The analysis stated in paragraph (c) of example (3) of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C’s interest in the land and C’s interest in the depreciable property.)

(d) Distributee partner’s tax consequences. C’s tax consequences on the distribution are as follows:

1. The section 751(b) sale or exchange. C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for $7,000, realizing a gain of $737.

2. The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution C’s basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,263, the bases of C’s shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C’s basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis for his partnership interest ($25,737 less $17,000, money received. Thus, C’s total aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(e) Partnership’s tax consequences. The tax consequences to the partnership on the distribution are as follows:

1. The section 751(b) sale or exchange. The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19ths of C’s interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C’s 7/19ths interest constructively distributed and
increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis ($9,000/9,000 of $1,105) of land constructively distributed to C, and increased by $1,105 (3,000/19,000 of $7,000), the portion of the purchase price allocated to the land.

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C’s basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution plus $12,000, each partner’s original share of the liabilities, plus $6,000, the share of C’s liabilities assumed, plus $1,050, each partner’s share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example (5). (a) Facts. Assume that partner C in example (2) of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C’s share of the partnership liabilities has been reduced by $4,800 from $12,000 (1/3 of $36,000) to $7,200 (1/5 of $36,000).

(b) Presence of section 751 property. For the same reasons as stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. C’s interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

<table>
<thead>
<tr>
<th>Item</th>
<th>C’s interest</th>
<th>Fair Market Value</th>
<th>C received Distribution of share</th>
<th>In excess of share</th>
<th>C relinquished</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>One-third</td>
<td>One-fifth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$2,000</td>
<td>$3,000</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td>Liabilities assumed</td>
<td>(12,000)</td>
<td>(7,200)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory Items:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>3,000</td>
<td>300</td>
<td>2,700</td>
<td>4,800</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>10,000</td>
<td>6,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciable property</td>
<td>16,000</td>
<td>9,600</td>
<td>6,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>3,000</td>
<td>1,800</td>
<td>1,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$25,000</td>
<td>$12,500</td>
<td>$5,700</td>
<td>$11,600</td>
<td>$11,600</td>
</tr>
</tbody>
</table>
Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C’s interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) Distributee partner’s tax consequences. C’s tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C’s interest are illustrated in the following table:

<table>
<thead>
<tr>
<th>If accounts receivable received for depreciable property</th>
<th>If accounts receivable received for land</th>
<th>If there is no agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original basis for C’s interest</td>
<td>$32,000</td>
<td>$32,000</td>
</tr>
<tr>
<td>Less basis of property distributed prior to sec. 751(b) sale or exchange</td>
<td>(700)</td>
<td>(800)</td>
</tr>
<tr>
<td></td>
<td>$31,300</td>
<td>$31,200</td>
</tr>
<tr>
<td>Less money received in distribution</td>
<td>(9,800)</td>
<td>(9,800)</td>
</tr>
<tr>
<td></td>
<td>$21,500</td>
<td>$21,400</td>
</tr>
<tr>
<td>Less basis of property received in a current distribution under sec. 732</td>
<td>(6,700)</td>
<td>(6,700)</td>
</tr>
<tr>
<td></td>
<td>$14,800</td>
<td>$14,700</td>
</tr>
<tr>
<td>Resulting basis for C’s interest</td>
<td></td>
<td>$14,784</td>
</tr>
</tbody>
</table>
C's basis for the $1,500 worth of accounts receivable which he received in the
distribution will be $7,500, composed of $800 for the portion purchased in the
section 751(b) exchange, plus $6,700, the basis carried over under section 732(a)
for the portion received in the current distribution.
(e) Partnership's tax consequences. The tax consequences to the partnership on the
distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership realizes no gain or loss in
the section 751 sale or exchange because it had a basis of $800 for the accounts
receivable for which it received $800 worth of other property. If the partnership
agreed to purchase $800 worth of depreciable property, the partnership basis of
depreciable property becomes $42,100 ($42,000 less $700 basis of property
constructively distributed to C, plus $800, price of property purchased). If the
partnership purchased land with the accounts receivable, there would be no change
in the basis of the land to the partnership because the basis of land distributed was
equal to its purchase price. If there were no agreement, the basis of the depreciable
property and land would be $51,084 (depreciable property, $42,084 and land
$9,000). The basis for the depreciable property is computed as follows: The
common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000
of $674) for C's $674 interest constructively distributed, and increased by $674
(6,400/7,600 of $800), the part of the purchase price allocated to the depreciable
property. The basis of the land would be computed in the same way. The $9,000
original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land
constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the
portion of the purchase price allocated to the land.

(2) The part of the distribution not under section 751(b). The partnership will realize
no gain or loss in the balance of the distribution under section 731. Since the
property in C's hands after the distribution will have the same basis it had in the
partnership, the basis of partnership property remaining in the partnership after the
distribution will not be adjusted (whether or not an election under 754 is in effect).

Example (6). (a) Facts. Partnership ABC distributes to partner C, in liquidation of his
entire one-third interest in the partnership, a machine which is section 1245 property
with a recomputed basis (as defined in section 1245(a)(2)) of $18,000. At the time of
the distribution, the balance sheet of the partnership is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis per books</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Machine (1245 property)</td>
<td>$9,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Land</td>
<td>$18,000</td>
<td>$27,000</td>
</tr>
<tr>
<td>Total</td>
<td>$30,000</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>Per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>
(b) Presence of section 751 property. The section 1245 property is an unrealized receivable of the partnership to the extent of the potential section 1245 income in respect of the property. Since the fair market value of the property ($15,000) is lower than its recomputed basis ($18,000), the excess of the fair market value over its adjusted basis ($9,000), or $6,000, is the potential section 1245 income of the partnership in respect of the property. The partnership has no other section 751 property.

(c) The properties exchanged. In the distribution C received his share of section 751 property (potential section 1245 income of $2,000, i.e., 1/3 of $6,000) and his share of section 1245 property (other than potential section 1245 income) with a fair market value of $3,000, i.e., 1/3 of ($15,000 minus $6,000), and an adjusted basis of $3,000, i.e., 1/3 of $9,000. In addition he received $4,000 of section 751 property (consisting of $4,000 ($6,000 minus $2,000) of potential section 1245 income) and section 1245 property (other than potential section 1245 income) with a fair market value of $6,000 ($9,000 minus $3,000) and an adjusted basis of $6,000 ($9,000 minus $3,000). C relinquished his interest in $1,000 of cash and $9,000 of land. Assume that the partners agree that the $4,000 of section 751 property in excess of C's share was received by him in exchange for $4,000 of land.

(d) Distributee partner's tax consequences. C's tax consequences on the distributions are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he received in a current distribution 4/9ths of his share of the land with a basis of $2,667 (18,000/27,000 x $4,000). Then C is considered as having sold his 4/9ths share of the land to the partnership for $4,000, realizing a gain of $1,333. C's basis for the remainder of his partnership interest after the current distribution is $7,333, i.e., the basis of his partnership interest before the current distribution ($10,000) minus the basis of the land treated as distributed to him ($2,667).

(2) The part of the distribution not under section 751(b). Of the $15,000 total distribution to C, $11,000 ($2,000 of potential section 1245 income and $9,000 section 1245 property other than potential section 1245 income) is not within section 751(b). Under section 732(b) and (c), C's basis for his share of potential section 1245 income is zero (see paragraph (c)(5) of this section) and his basis for $9,000 of section 1245 property (other than potential section 1245 income) is $7,333, i.e., the amount of the remaining basis for his partnership interest ($7,333) reduced by the basis for his share of potential section 1245 income (zero). Thus C's total aggregate basis for the section 1245 property (fair market value of $15,000) distributed to him is $11,333 ($4,000 plus $7,333). For an illustration of the computation of his recomputed basis for the section 1245 property immediately after the distribution, see example (2) of paragraph (f)(3) of section 1.1245-4.

<table>
<thead>
<tr>
<th>Capital</th>
<th>$10,000</th>
<th>$15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>B</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>C</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total</td>
<td>$30,000</td>
<td>$45,000</td>
</tr>
</tbody>
</table>
(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. Upon the sale of $4,000 potential section 1245 income, with a basis of zero, for 4/9ths of C's interest in the land, the partnership consisting of the remaining members has $4,000 ordinary income under sections 751(b) and 1245(a)(1). See section 1245(b)(3) and (6)(A). The partnership's new basis for the land is $19,333, i.e., $18,000, less the basis of the 4/9ths share considered as distributed to C ($2,667), plus the partnership purchase price for this share ($4,000).

(2) The part of the distribution not under section 751(b). The analysis under this subparagraph should be made in accordance with the principles illustrated in paragraph (e)(2) of examples (3), (4), and (5) of this paragraph.


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Sec. 1.752-1 TREATMENT OF PARTNERSHIP LIABILITIES.

(a) DEFINITIONS.

For purposes of section 752, the following definitions apply:

(1) RECOURSE LIABILITY DEFINED.

A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under section 1.752-2.

(2) NONRECOURSE LIABILITY DEFINED.

A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under section 1.752-2.

(3) RELATED PERSON.

Related person means a person having a relationship to a partner that is described in section 1.752-4 (b).

(b) INCREASE IN PARTNER'S SHARE OF LIABILITIES.

Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership.

(c) DECREASE IN PARTNER'S SHARE OF LIABILITIES.

Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.

(d) ASSUMPTION OF LIABILITY.

Except as otherwise provided in paragraph (e) of this section, a person is considered to assume a liability only to the extent that:

(1) The assuming person is personally obligated to pay the liability; and

(2) If a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce
the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.

(e) PROPERTY SUBJECT TO A LIABILITY.

If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.

(f) NETTING OF INCREASES AND DECREASES IN LIABILITIES RESULTING FROM, SAME TRANSACTION.

If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability or the termination of the partnership under section 708(b) will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.

(g) EXAMPLE.

The following example illustrates the principles of paragraphs (b), (c), (e), and (f) of this section.

EXAMPLE. PROPERTY CONTRIBUTED SUBJECT TO A LIABILITY; NETTING OF INCREASE AND DECREASE IN PARTNER'S SHARE OF LIABILITY. B contributes property with an adjusted basis of $1,000 to a general partnership in exchange for a one-third interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of $150 and has a fair market value in excess of $150. After the contribution, B remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under paragraph (e) of this section, the partnership is treated as having assumed the $150 liability. As a result, B's individual liabilities decrease by $150. At the same time, however, B's share of liabilities of the partnership increases by $150. Only the net increase or decrease in B's share of the liabilities of the partnership and B's individual liabilities is taken into account in applying section 752. Because there is no net change, B is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership under paragraph (b) or (c) of this section. Therefore B's basis for B's partnership interest is $1,000 (B's basis for the contributed property).
(h) SALE OR EXCHANGE OF A PARTNERSHIP INTEREST.

If a partnership interest is sold or exchanged, the reduction in the transferor partner’s share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder. For example, if a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner’s share of partnership liabilities in the amount of $250, the seller realizes $1,000 on the transaction.

(i) BIFURCATION OF PARTNERSHIP LIABILITIES.

If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.


Sec. 1.752-2 PARTNER’S SHARE OF RECourse LIABILITIES.

(a) IN GENERAL.

A partner’s share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (j) of this section.

(b) OBLIGATION TO MAKE A PAYMENT.

(1) IN GENERAL.

Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

(i) All of the partnership’s liabilities become payable in full;

(ii) With the exception of property contributed to secure a partnership liability (see section 1.752-2 (h)(2)), all of the partnership’s assets, including cash, have a value of zero;
(iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);

(iv) All items of income, gain, loss, or deduction are allocated among the partners; and

(v) The partnership liquidates.

(2) TREATMENT UPON DEEMED DISPOSITION.

For purposes of paragraph (b)(1) of this section, gain or loss on the deemed disposition of the partnership's assets is computed in accordance with the following:

(i) If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent section 704(c) or section 1.704-1(b)(4)(i) applies) in those assets.

(ii) A loss is recognized equal to the remaining tax basis (or book value to the extent section 704(c) or section 1.704-1(b)(4)(i) applies) of all of the partnership's assets not taken into account in paragraph (b)(2)(i) of this section.

(3) OBLIGATIONS RECOGNIZED.

The determination of the extent to which a partner or related person has an obligation to make a payment under paragraph (b)(1) of this section is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including:

(i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;

(ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

(iii) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), paragraph (b) of this section is applied as if the obligation did not exist.

(4) CONTINGENT OBLIGATIONS.
A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

(5) REIMBURSEMENT RIGHTS.

A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner.

(6) DEEMED SATISFACTION OF OBLIGATION.

For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. See section 1.752-2(j).

(c) PARTNER OR RELATED PERSON AS LENDER --

(1) IN GENERAL.

A partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.

(2) WRAPPED DEBT.

If a partnership liability is owed to a partner or related person and that liability includes (i.e., is "wrapped" around) a nonrecourse obligation encumbering partnership property that is owed to another person, the partnership liability will be treated as two separate liabilities. The portion of the partnership liability corresponding to the wrapped debt is treated as a liability owed to another person.

(d) DE MINIMIS EXCEPTIONS --

(1) PARTNER AS LENDER.

The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed).
(2) PARTNER AS GUARANTOR.

The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.

(e) SPECIAL RULE FOR NONRECOURSE LIABILITY WITH INTEREST GUARANTEED BY A PARTNER --

(1) IN GENERAL.

For purposes of this section, if one or more partners or related persons have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities. If this rule applies, the partner or related person that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a nonrecourse liability. Generally, in applying this rule, it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if, upon a default in payment by the partnership, the lender can enforce the interest guaranty without foreclosing on the property and thereby extinguishing the underlying debt. The guarantee of interest rule continues to apply even after the point at which the amount of guaranteed interest that will accrue is less than 25 percent of the total interest that will accrue on the liability.

(2) COMPUTATION OF PRESENT VALUE.

The present value of the guaranteed future interest payments is computed using a discount rate equal to either the interest rate stated in the loan documents, or if interest is imputed under either section 483 or section 1274, the applicable federal rate, compounded semi-annually. The computation takes into account any payment of interest that the partner or related person may be required to make only to the extent that the interest will accrue economically (determined in accordance with section 446 and the regulations thereunder) after the date of the interest guarantee. If the loan document contains a variable rate of interest that is an interest rate based on current values of an objective interest index, the present value is computed on the assumption that the interest determined under the objective interest index on the date of the computation will remain constant over the term of the loan. The term "objective interest index" has the meaning given to it in section 1275 and the regulations thereunder (relating to variable rate debt instruments). Examples of an objective interest
index include the prime rate of a designated financial institution, LIBOR (London Interbank Offered Rate], and the applicable federal rate under section 1274(d).

(3) SAFE HARBOR.

The general rule contained in paragraph (e)(1) of this section does not apply to a partnership nonrecourse liability if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability.

(4) DE MINIMIS EXCEPTION.

The general rule contained in paragraph (e)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees the interest on a loan to that partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). An allocation of interest to the extent paid by the guarantor is not treated as a partnership item of deduction or loss subject to the 10 percent or less rule.

(f) EXAMPLES.

The following examples illustrate the principles of paragraphs (a) through (e) of this section.

EXAMPLE 1. DETERMINING WHEN A PARTNER BEARS THE ECONOMIC RISK OF LOSS. A and B form a general partnership with each contributing $100 in cash. The partnership purchases an office building on leased land for $1,000 from an unrelated seller, paying $200 in cash and executing a note to the seller for the balance of $800. The note is a general obligation of the partnership, i.e., no partner has been relieved from personal liability. The partnership agreement provides that all items are allocated equally except that tax losses are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under section 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the $800 liability becomes due and payable. All of the partnership's assets, including the building, are deemed to be worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Loss on hypothetical sale</td>
<td>($900)</td>
<td>($100)</td>
</tr>
<tr>
<td>($800)</td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, $800 of the partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for non-payment. B has no share of the $800 liability since the
constructive liquidation produces no payment obligation for B. A’s share of the partnership liability is $800 because A would have an obligation in that amount to make a contribution to the partnership.

EXAMPLE 2. REcourse LIABILITY; DEFICIT RESTORATION OBLIGATION. C and D each contribute $500 in cash to the capital of a new general partnership, CD. CD purchases property from an unrelated seller for $1,000 in cash and a $9,000 mortgage note. The note is a general obligation of the partnership, i.e., no partner has been relieved from personal liability. The partnership agreement provides that profits and losses are to be divided 40% to C and 60% to D. C and D are required to make up any deficit in their capital accounts. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

<table>
<thead>
<tr>
<th></th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Loss on hypothetical sale</td>
<td>(4,000)</td>
<td>(6,000)</td>
</tr>
</tbody>
</table>

C’s capital account reflects a deficit that C would have to make up of $3,500 and D’s capital account reflects a deficit that D would have to make up of $5,500. Therefore, the $9,000 mortgage note is a recourse liability because one or more partners bear the economic risk of loss for the liability. C’s share of the recourse liability is $3,500 and D’s share is $5,500.

EXAMPLE 3. GUARANTEE BV LIMITED PARTNER; PARTNER DEEMED TO SATISFY OBLIGATION. E and F form a limited partnership. E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000 in cash to the partnership. The partnership agreement allocates losses 20% to E and 80% to F until F’s capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for $25,000 using its $10,000 cash and a $15,000 recourse loan from a bank. F guarantees payment of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. In a constructive liquidation, the $15,000 liability becomes due and payable. All of the partnership’s assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

<table>
<thead>
<tr>
<th></th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$2,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Loss on hypothetical sale</td>
<td>(17,000)</td>
<td>(8,000)</td>
</tr>
</tbody>
</table>

E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of $15,000. Because E is assumed to satisfy that obligation, it is also assumed that F would not have to satisfy F’s guarantee. The $15,000 mortgage is treated as a recourse liability because one or more partners
bear the economic risk of loss. E’s share of the liability is $15,000, and F’s share is zero. This would be so even if E’s net worth at the time of the determination is less than $15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E’s obligation to contribute to the partnership.

**EXAMPLE 4. PARTNER GUARANTEE WITH RIGHT OF SUBROGATION.** G, a limited partner in the GH partnership, guarantees a portion of a partnership liability. The liability is a general obligation of the partnership, i.e., no partner has been relieved from personal liability. If under state law G is subrogated to the rights of the lender, G would have the right to recover the amount G paid to the recourse lender from the general partner. Therefore, G does not bear the economic risk of loss for the partnership liability.

**EXAMPLE 5. BIFURCATION OF PARTNERSHIP LIABILITY; GUARANTEE OF PART OF NONRECOURSE LIABILITY.** A partnership borrows $10,000, secured by a mortgage on real property. The mortgage note contains an exoneration clause which provides that in the event of default, the holder’s only remedy is to foreclose on the property. The holder may not look to any other partnership asset or to any partner to pay the liability. However, to induce the lender to make the loan, a partner guarantees payment of $200 of the loan principal. The exoneration clause does not apply to the partner’s guarantee. If the partner paid pursuant to the guarantee, the partner would be subrogated to the rights of the lender with respect to $200 of the mortgage debt, but the partner is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, $200 of the $10,000 mortgage liability is treated as a recourse liability of the partnership and $9,800 is treated as a nonrecourse liability of the partnership. The partner’s share of the recourse liability of the partnership is $200.

**EXAMPLE 6. WRAPPED DEBT.** I, an individual, purchases real estate from an unrelated seller for $10,000, paying $1,000 in cash and giving a $9,000 purchase mortgage note on which I has no personal liability and as to which the seller can look only to the property for satisfaction. At a time when the property is worth $15,000, I sells the property to a partnership in which I is a general partner. The partnership pays for the property with a partnership purchase money mortgage note of $15,000 on which neither the partnership nor any partner (or person related to a partner) has personal liability. The $15,000 mortgage note is a wrapped debt that includes the $9,000 obligation to the original seller. The liability is a recourse liability to the extent of $6,000 because I is the creditor with respect to the loan and I bears the economic risk of loss for $6,000. I’s share of the recourse liability is $6,000. The remaining $9,000 is treated as a partnership nonrecourse liability that is owed to the unrelated seller.

**EXAMPLE 7. GUARANTEE OF INTEREST BY PARTNER TREATED AS PART RECOURSE AND CART NONRECOURSE.** On January 1, 1992, a partnership obtains a $4,000,000 loan secured by a shopping center owned by the partnership. Neither the partnership nor any partner has any personal liability under the loan documents for repayment of the stated principal amount. Interest accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal is payable in a lump sum on December 31, 2006. A partner guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the
loan, the present value (discounted at 15 percent, compounded annually) of the future interest payments is $3,508,422, and of the future principal payment is $491,578. If tested on that date, the loan would be treated as a partnership liability of $1,754,211 ($3,508,422 x.5) for which the guaranteeing partner bears the economic risk of loss and a partnership nonrecourse liability of $2,245,789 ($1,754,211 + $491,578).

**EXAMPLE 8. CONTINGENT OBLIGATION NOT RECOGNIZED.** J and K form a general partnership with cash contributions of $2,500 each. J and K share partnership profits and losses equally. The partnership purchases an apartment building for its $5,000 of cash and a $20,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the building. The loan documents provide that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in the value of the apartment building resulting from the partnership's failure properly to maintain the property. There are no facts that establish with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership's failure properly to maintain the building. Therefore, no partner bears the economic risk of loss, and the liability constitutes a nonrecourse liability. Under section 1.752-3, J and K share this nonrecourse liability equally because they share all profits and losses equally.

(g) TIME-VALUE-OF-MONEY CONSIDERATIONS --

(1) IN GENERAL.

The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in the time when a payment or contribution obligation with respect to a partnership liability is to be satisfied. If a payment obligation with respect to a partnership liability is not required to be satisfied within a reasonable time after the liability becomes due and payable, or if the obligation to make a contribution to the partnership is not required to be satisfied before the later of --

(i) The end of the year in which the partner's interest is liquidated, or

(ii) 90 days after the liquidation,

the obligation is recognized only to the extent of the value of the obligation.

(2) VALUATION OF AN OBLIGATION.

The value of a payment or contribution obligation that is not required to be satisfied within the time period specified in paragraph (g)(1) of this section equals the entire principal balance of the obligation only if the obligation bears interest equal to or greater than the applicable federal rate under section 1274(d) at the time of valuation, commencing on --

(i) In the case of a payment obligation, the date that the partnership liability to a creditor or other person to whom the obligation relates becomes due and payable, or
(ii) In the case of a contribution obligation, the date of the liquidation of the partner's interest in the partnership.

If the obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is discounted to the present value of all payments due from the partner or related person (i.e., the imputed principal amount computed under section 1274(b)). For purposes of making this present value determination, the partnership is deemed to have constructively liquidated as of the date on which the payment obligation is valued and the payment obligation is assumed to be a debt instrument subject to the rules of section 1274 (i.e., the debt instrument is treated as if it were issued for property at the time of the valuation).

(3) SATISFACTION OF OBLIGATION WITH PARTNER'S PROMISSORY NOTE.

An obligation is not satisfied by the transfer to the obligee of a promissory note by a partner or related person unless the note is readily tradeable on an established securities market.

(4) EXAMPLE.

The following example illustrates the principle of paragraph (g) of this section.

EXAMPLE. VALUE OF OBLIGATION NOT REQUIRED TO BE SATISFIED WITHIN SPECIFIED TIME PERIOD. A, the general partner, and B, the limited partner, each contributes $10,000 to partnership AB. AB purchases property from an unrelated seller for $20,000 in cash and a $70,000 recourse purchase money note. The partnership agreement provides that profits and losses are to be divided equally. A and B are required to make up any deficit in their capital accounts. While A is required to restore any deficit balance in A's capital account within 90 days after the date of liquidation of the partnership, B is not required to restore any deficit for two years following the date of liquidation. The deficit in B's capital account will not bear interest during that two-year period. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Loss on hypothetical sale</td>
<td>$(45,000)</td>
<td>$(45,000)</td>
</tr>
<tr>
<td></td>
<td>$(35,000)</td>
<td>$(35,000)</td>
</tr>
</tbody>
</table>

A's and B's capital accounts each reflect deficits of $35,000. B's obligation to make a contribution pursuant to B's deficit restoration obligation is recognized only to the extent of the fair market value of that obligation at the time of the constructive liquidation because B is not required to satisfy that obligation by the later of the end of the partnership taxable year in which B's interest is liquidated.
or within 90 days after the date of the liquidation. Because B's obligation does not bear interest, the fair market value is deemed to equal the imputed principal amount under section 1274(b). Under section 1274(b), the imputed principal amount of a debt instrument equals the present value of all payments due under the debt instrument. Assume the applicable federal rate with respect to B's obligation is 10 percent compounded semiannually. Using this discount rate, the present value of the $35,000 payment that B would be required to make two years after the constructive liquidation to restore the deficit balance in B's capital account equals $28,795. To the extent that B's deficit restoration obligation is not recognized, it is assumed that B's obligation does not exist. Therefore, A, as the sole general partner, would be obligated by operation of law to contribute an additional $6,205 of capital to the partnership. Accordingly, under paragraph (g) of this section, B bears the economic risk of loss for $28,795 and A bears the economic risk of loss for $41,205 ($35,000 + $6,205).

(h) PARTNER PROVIDING PROPERTY AS SECURITY FOR PARTNERSHIP LIABILITY

(1) DIRECT PLEDGE.

A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any of the partner's or related person's separate property (other than a direct or indirect interest in the partnership) that is pledged as security for the partnership liability.

(2) INDIRECT PLEDGE.

A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any property that the partner contributes to the partnership solely for the purpose of securing a partnership liability. Contributed property is not treated as contributed solely for the purpose of securing a partnership liability unless substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.

(3) VALUATION.

The extent to which a partner bears the economic risk of loss as a result of a direct pledge described in paragraph (h)(1) of this section or an indirect pledge described in paragraph (h)(2) of this section is limited to the fair market value of the property at the time of the pledge of contribution.

(4) PARTNER'S PROMISSORY NOTE.

For purposes of paragraph (h)(2) of this section, a promissory note of the partner or related person that is contributed to the partnership shall not be taken into account unless the note is readily tradeable on an established securities market.

(i) TREATMENT OF RECOUSE LIABILITIES IN TIERED PARTNERSHIPS.
If a partnership (the "upper-tier partnership") owns (directly or indirectly through one or more partnerships) an interest in another partnership (the "lower-tier partnership"), the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following --

(1) The amount of the economic risk of loss that the upper-tier partnership bears with respect to the liabilities; and

(2) Any other amount of the liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss.

(j) ANTI-ABUSE RULES --

(1) IN GENERAL.

An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

(2) ARRANGEMENTS TANTAMOUNT TO A GUARANTEE.

Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that:

(i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;

(ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(iii) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

The partners are considered to bear the economic risk of loss for the liability in accordance with their relative economic burden for the liability result to the contractual obligations. For example, a lease between a partner and a partnership which is not on commercially reasonable terms may be tantamount to a guarantee by the partner of a partnership liability.

(3) PLAN TO CIRCUMVENT OR AVOID THE OBLIGATION.

An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.
The following example illustrates the principle of paragraph (j)(3) of this section.

EXEMPLARY PLAN TO CIRCUMVENT OR AVOID OBLIGATION. A and B form a general partnership. A, a corporation, contributes $20,000 and B contributes $80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. B guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary, formed by a parent of a consolidated group, with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses generated by the property while at the same time limiting its monetary exposure for such losses. These facts, when considered together with B's guarantee, indicate a plan to circumvent or avoid A's obligation to contribute to the partnership. The rules of section 752 must be applied as if A's obligation to contribute did not exist. Accordingly, the $150,000 liability is a recourse liability that is allocated entirely to B.

Sec. 1.752-3 PARTNER'S SHARE OF NONRECURSE LIABILITIES.

(a) IN GENERAL.

A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows --

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.
The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Excess nonrecourse liabilities are not required to be allocated under the same method each year.

(b) EXAMPLES.

The following examples illustrate the principles of paragraph (a) of this section.

EXAMPLE 1. PARTNER'S SHARE OF NONRECOURSE LIABILITIES. The AB partnership purchases depreciable property for a $1,000 purchase money note that is a nonrecourse liability under the rules of this section. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement provides that all items of income, gain, loss, and deduction are allocated equally. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they have equal interests in partnership profits. A and B are each treated as if they contributed $500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from $0 to $500). The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims a depreciation deduction of $200 for the depreciable property for the year it acquires that property, partnership minimum gain for the year will increase by $200 (the excess of the $1,000 nonrecourse liability over the $800 adjusted tax basis of the property). See section 704(b) and the regulations thereunder. A and B each have a $100 share of partnership minimum gain at the end of that year because the depreciation deduction is treated as a nonrecourse deduction. See section 704(b) and the regulations thereunder. Accordingly, at the end of that year, A and B are allocated $100 each of the nonrecourse liability to match their shares of partnership minimum gain. The remaining $800 of the nonrecourse liability will be allocated equally between A and B ($400 each).

EXAMPLE 2. EXCESS NONRECOURSE LIABILITIES ALLOCATED CONSISTENTLY WITH REASONABLY EXPECTED DEDUCTIONS. The facts are the same as in Example 1 except that the partnership agreement provides that depreciation deductions will be allocated to A. The partners agree to allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Assuming that the allocation of all of the depreciation deductions to A is valid under section 704(b), immediately after purchasing the depreciable property, A's share of the nonrecourse liability is $1,000. Accordingly, A is treated as if A contributed $1,000 to the partnership.
Sec. 1.752-4 SPECIAL RULES.

(a) TIERED PARTNERSHIPS.

An upper-tier partnership’s share of the liabilities of a lower-tier partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

(b) RELATED PERSON DEFINITION. --

1) IN GENERAL.

A person is related to a partner if the person and the partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1), subject to the following modifications:

   (i) Substitute "80 percent or more" for "more than 50 percent" each place it appears in those sections;
   (ii) A person's family is determined by excluding brothers and sisters; and
   (iii) Disregard sections 267(e)(1) and 267(f)(1)(A).

2) PERSON RELATED TO MORE THAN ONE PARTNER --

   (i) IN GENERAL.

   If, in applying the related person rules in paragraph (b)(1) of this section, a person is related to more than one partner, paragraph (b)(1) of this section is applied by treating the person as related only to the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated equally among the partners having the equal percentages of related ownership.

   (ii) NATURAL PERSONS.

   For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other.

   (iii) Related partner exception.

   Notwithstanding paragraph (b)(1) of this section (which defines related person), persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the
partnership. This paragraph (iii) does not apply when determining a partner's interest under the de minimis rules in section 1.752-2(d) and (e).

(iv) SPECIAL RULE WHERE ENTITY STRUCTURED TO AVOID RELATED PERSON STATUS --

(A) IN GENERAL.

If --

(1) A partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust;

(2) A partner or related person owns (directly or indirectly) a 20 percent or more ownership interest in the other entity; and

(3) A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner that owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability;

then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity.

(B) OWNERSHIP INTEREST.

For purposes of paragraph (b)(2)(iv)(A) of this section, a person's ownership interest in:

(1) A partnership equals the partner's highest percentage interest in any item of partnership loss or deduction for any taxable year;

(2) An S corporation equals the percentage of the outstanding stock in the S corporation owned by the shareholder;

(3) A C corporation equals the percentage of the fair market value of the issued and outstanding stock owned by the shareholder; and

(4) A trust equals the percentage of the actuarial interests owned by the beneficial owner of the trust.

(C) EXAMPLE. ENTITY STRUCTURED TO AVOID RELATED PERSON STATUS. A, B, and C form a general partnership, ABC. A, B, and C are equal partners, each contributing $1,000 to the partnership. A and B want to loan money to ABC and have the loan treated as nonrecourse for purposes of section 752. A and B form partnership AB to which each contributes $50,000. A and B share losses equally in partnership AB. Partnership AB loans partnership ABC $100,000 on a nonrecourse basis secured by the property ABC buys with the loan. Under these facts and circumstances, A and B bear the economic risk of loss with respect to the partnership liability equally based on their percentage interest in losses of partnership AB.
(c) LIMITATION.

The amount of an indebtedness is taken into account only once, even though a partner (in addition to the partner’s liability for the indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

(d) TIME OF DETERMINATION.

A partner’s share of partnership liabilities must be determined whenever the determination is necessary in order to determine the tax liability of the partner or any other person. See section 1.705-1(a) for rules regarding when the adjusted basis of a partner’s interest in the partnership must be determined.


Sec. 1.752-5 EFFECTIVE DATES AND TRANSITION RULES.

(a) IN GENERAL.

Unless a partnership makes an election under paragraph (b)(1) of this section to apply the provisions of sections 1.752-1 through 1.752-4 earlier, sections 1.752-1 through 1.752-4 apply to any liability incurred or assumed by a partnership on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. For liabilities incurred or assumed by a partnership prior to December 28, 1991 (or pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter), unless an election to apply these regulations has been made, see sections 1.752-0T to 1.752-4T, set forth in 26 CFR 1.752-0T through 1.752-4T as contained in 26 CFR edition revised April 1, 1991, (TD 8237, TD 8274, and TD TD 8355) and section 1.752-1, set forth in 23 CFR 1.752-1 as contained in 26 CFR edition revised April 1, 1988 (TD 6175 and TD 6500).

(b) ELECTION --

(1) IN GENERAL.

A partnership may elect to apply the provisions of sections 1.752-1 through 1.752-4 to all of its liabilities to which the provisions of those sections do not otherwise apply as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991.

(2) TIME AND MANNER OF ELECTION.

An election under this paragraph (b) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the
statement and contain a declaration that an election is being made under this paragraph (b).

(c) EFFECT OF SECTION 708(B)(1)(B) TERMINATION ON DETERMINING DATE LIABILITIES ARE INCURRED OR ASSUMED.

For purposes of applying this section, a termination of the partnership under section 708(b)(1)(B) will not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of the termination.


Sec. 1.753-1 Partner receiving income in respect of decedent.

(a) Income in respect of a decedent under section 736(a).

All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

(b) Other income in respect of a decedent.

When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes. See paragraph (c) (3) of section 1.706-1.

(c) Example.

The provisions of this section may be illustrated by the following example:

Example. A and the decedent B were equal partners in a business having assets (other than money) worth $40,000 with an adjusted basis of $10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of $10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus $10,000 in each of the three years after death. B's share of
earnings to the date of his death was $4,000, of which he had withdrawn $3,000. B’s distributive share of partnership income of $4,000 to the date of his death is income in respect of a decedent (although only the $1,000 undrawn at B’s death will be reflected in the value of B’s partnership interest on B’s estate tax return). Assume that the value of B’s interest in partnership property at the date of his death was $22,000, composed of the following items: B’s one-half share of the assets of $40,000, plus $2,000, B’s interest in partnership cash. It should be noted that B’s $1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partnership assets. Under the partnership agreement, A is to pay B’s estate a total of $31,000. The difference of $9,000 between the amount to be paid by A ($31,000) and the value of B's interest in partnership property ($22,000) comes within section 736(a) and, thus, also constitutes income in respect of a decedent. (However, the $17,000 difference between the $5,000 basis for B’s share of the partnership property and its $22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B’s estate $11,000, of which they agree to allocate $3,000 as the payment under section 736(a), B’s estate will include $7,000 in its gross income (B’s $4,000 distributive share plus $3,000 payment under section 736(a)). In computing the deduction under section 691(c), this $7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only $4,000 ($1,000 of distributive share not withdrawn, plus $3,000, payment under section 736(a)) of this amount can be identified on the estate tax return as part of the partnership interest.

(d) Effective date.

The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and paragraph (b)(4) of section 1.771-1.

Sec. 1.754-1 Time and manner of making election to adjust basis of partnership property.

(a) In general.

A partnership may adjust the basis of partnership property under sections 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) Time and method of making election.

(1) An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership,
shall be made in a written statement filed with the partnership return for the
taxable year during which the distribution or transfer occurs. For the election to
be valid, the return must be filed not later than the time prescribed by paragraph
(e) of section 1.6031-1 (including extensions thereof) for filing the return for such
taxable year (or before August 23, 1956, whichever is later). Notwithstanding the
preceding two sentences, if a valid election has been made under section 754
and this section for a preceding taxable year and not revoked pursuant to
paragraph (c) of this section, a new election is not required to be made. The
statement required by this subparagraph shall (i) set forth the name and address
of the partnership making the election, (ii) be signed by any one of the partners,
and (iii) contain a declaration that the partnership elects under section 754 to
apply the provisions of section 734(b) and section 743(b). For rules regarding
extensions of time for filing elections, see section 1.9100-1.

(2) The principles of this paragraph may be illustrated by the following
example:

Example. A, a U.S. citizen, is a member of partnership ABC, which has not
previously made an election under section 754 to adjust the basis of partnership
property. The partnership and the partners use the calendar year as the taxable
year. A sells his interest in the partnership to D on January 1, 1971. The
partnership may elect under section 754 and this section to adjust the basis of
partnership property under sections 734(b) and 743(b). Unless an extension of
time to make the election is obtained under the provisions of section 1.9100-1,
the election must be made in a written statement filed with the partnership return
for 1971 and must contain the information specified in subparagraph (1) of this
paragraph. Such return must be filed by April 17, 1972 (unless an extension of
time for filing the return is obtained). The election will apply to all distributions of
property to a partner and transfers of an interest in the partnership occurring in
1971 and subsequent years, unless revoked pursuant to paragraph (c) of this
section.

(c) Revocation of election.

(1) IN GENERAL.

(2) Revocations effective on December 15, 1999.

Notwithstanding paragraph (c)(1) of this section, any partnership having an
election in effect under this section for its taxable year that includes December
15, 1999, may revoke such election effective for transfers or distributions
occurring on or after December 15, 1999, by attaching a statement to the
partnership's return for such year. For the revocation to be valid, the statement
must be filed not later than the time prescribed by section 1.6031(a)-1(e)
(including extensions thereof) for filing the return for such taxable year, and must
set forth the name and address of the partnership revoking the election, be
signed by any one of the partners who is authorized to sign the partnership's
federal income tax return, and contain a declaration that the partnership revokes
its election under section 754 to apply the provisions of section 734(b) and
743(b). In addition, the following statement must be prominently displayed in
capital letters on the first page of the partnership's return for such year:
"RETURN FILED PURSUANT TO section 1.754-1(c)(2)."
Sec. 1.755-1 Rules for allocation of basis.

(a) GENERALLY.

A partnership that has an election in effect under section 754 must adjust the basis of partnership property under the provisions of section 734(b) and section 743(b) pursuant to the provisions of this section. The basis adjustment is first allocated between the two classes of property described in section 755(b). These classes of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. The portion of the basis adjustment allocated to each class is then allocated among the items within the class. Adjustments under section 743(b) are allocated under paragraph (b) of this section. Adjustments under section 734(b) are allocated under paragraph (c) of this section.

(b) ADJUSTMENTS UNDER SECTION 743(B) --

(1) GENERALLY.

(i) For exchanges in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest, paragraph (b)(5) of this section shall apply. For all other transfers which result in a basis adjustment under section 743(b), paragraphs (b)(2) through (b)(4) of this section shall apply. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

(ii) HYPOTHETICAL TRANSACTION.

For purposes of paragraphs (b)(2) through (b)(4) of this section, the allocation of the basis adjustment under section 743(b) between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss (including remedial allocations under section 1.704-3(d)) that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash
in an amount equal to the fair market value of such property (the hypothetical transaction).

(2) ALLOCATIONS BETWEEN CLASSES OF PROPERTY --

(i) IN GENERAL.

The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations under section 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction. The amount of the basis adjustment to capital gain property is equal to --

(A) The total amount of the basis adjustment under section 743(b); less

(B) The amount of the basis adjustment allocated to ordinary income property under the preceding sentence; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under section 1.704-3(d) from the hypothetical transaction) in capital gain property. In the event that a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.

(ii) EXAMPLES.

The provisions of this paragraph (b)(2) are illustrated by the following examples:

EXAMPLE 1. (i) A and B form equal partnership PRS. A contributes $50,000 and Asset 1, a nondepreciable capital asset with a fair market value of $50,000 and an adjusted tax basis of $25,000. B contributes $100,000. PRS uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for $120,000. At the time of the transfer, A's share of the partnership's basis in partnership assets is $75,000. Therefore, T receives a $45,000 basis adjustment.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 1</td>
<td>$25,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Asset 2</td>
<td>$100,000</td>
<td>$117,500</td>
</tr>
</tbody>
</table>

Ordinary Income Property:
(iii) If PRS sold all of its assets in a fully taxable transaction at fair market value immediately after the transfer of the partnership interest to T, the total amount of capital gain that would be allocated to T is equal to $46,250 ($25,000 section 704(c) built-in gain from Asset 1, plus fifty percent of the $42,500 appreciation in capital gain property). T would also be allocated a $1,250 ordinary loss from the sale of the ordinary income property.

(iv) The amount of the basis adjustment that is allocated to ordinary income property is equal to ($1,250) (the amount of the loss allocated to T from the hypothetical sale of the ordinary income property).

(v) The amount of the basis adjustment that is allocated to capital gain property is equal to $46,250 (the amount of the basis adjustment, $45,000, less ($1,250), the amount of loss allocated to T from the hypothetical sale of the ordinary income property).

EXAMPLE 2. (i) A and B form equal partnership PRS. A and B each contribute $1,000 cash which the partnership uses to purchase Assets 1, 2, 3, and 4. After a year, A sells its partnership interest to T for $1,000. T's basis adjustment under section 743(b) is zero.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 1</td>
<td>$500</td>
<td>$750</td>
</tr>
<tr>
<td>Asset 2</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Ordinary Income Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 3</td>
<td>$500</td>
<td>$250</td>
</tr>
<tr>
<td>Asset 4</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Total</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

(iii) If, immediately after the transfer of the partnership interest to T, PRS sold all of its assets in a fully taxable transaction at fair market value, T would be allocated a loss of $125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is ($125). The amount of the basis adjustment to capital gain property is $125 (zero, the amount of the basis adjustment under section 743(b), less ($125), the amount of the basis adjustment allocated to ordinary income property).

(3) ALLOCATION WITHIN THE CLASS --

(i) ORDINARY INCOME PROPERTY.
The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to --

(A) The amount of income, gain, or loss (including any remedial allocations under section 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; minus

(B) The product of --

(1) Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to the last sentence of paragraph (b)(2)(i) of this section; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

(ii) CAPITAL GAIN PROPERTY. The amount of the basis adjustment to each item of property within the class of capital gain property is equal to --

(A) The amount of income, gain, or loss (including any remedial allocations under section 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; minus

(B) The product of --

(1) The total amount of gain or loss (including any remedial allocations under section 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

(iii) EXAMPLES.

The provisions of this paragraph (b)(3) are illustrated by the following examples:

EXAMPLE 1. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section. Of the $45,000 basis adjustment, $46,250 was allocated to capital gain property. The amount allocated to ordinary income property was ($1,250).
(ii) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 1 is $37,500.

(iii) Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 2 is $8,750.

(iv) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(v) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

EXAMPLE 2. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section, except that A sold its interest in PRS to T for $110,000 rather than $120,000. T, therefore, receives a basis adjustment under section 743(b) of $35,000. Of the $35,000 basis adjustment, ($1,250) is allocated to ordinary income property, and $36,250 is allocated to capital gain property.

(ii) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(iii) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

(iv) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. The total amount of gain that would be allocated to T from the sale of the capital gain assets in the hypothetical transaction is $46,250, which exceeds the amount of the basis adjustment allocated to capital gain property by $10,000. The amount of the adjustment to Asset 1 is $33,604 ($37,500 minus $3,896 ($10,000 x $75,000/192,500)). The amount of the basis adjustment to Asset 2 is $2,646 ($8,750 minus $6,104 ($10,000 x $117,500/192,500)).

(4) INCOME IN RESPECT OF A DECEDEDENT --

(i) IN GENERAL.

Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. See section 1.742-1. Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis
adjustment under section 743(b) is allocated to these assets. See section 1.743-1(b).

(ii) The provisions of this paragraph (b)(4) are illustrated by the following example:

EXAMPLE. (i) A and B are equal partners in personal service partnership PRS. As a result of B's death, B's partnership interest is transferred to T when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Asset</td>
<td>$2,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Unrealized Receivables</td>
<td>$0</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total</td>
<td>$2,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital:</td>
</tr>
<tr>
<td>A</td>
</tr>
<tr>
<td>B</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

(ii) None of the assets owned by PRS is section 704(c) property, and the capital asset is nondepreciable. The fair market value of T's partnership interest on the applicable date of valuation set forth in section 1014 is $10,000. Of this amount, $2,500 is attributable to T's share of the partnership's capital asset, and $7,500 is attributable to T's 50% share of the partnership's unrealized receivables. The partnership's unrealized receivables represent income in respect of a decedent. Accordingly, under section 1014(c), T's basis in its partnership interest is not adjusted for that portion of the interest which is attributable to the unrealized receivables. Therefore, T's basis in its partnership interest is $2,500.

(iii) At the time of the transfer, B's share of the partnership's basis in partnership assets is $1,000. Accordingly, T receives a $1,500 basis adjustment under section 743(b). Under this paragraph (b)(4), the entire basis adjustment is allocated to the partnership's capital asset.

(5) TRANSFERRED BASIS EXCHANGES --

(i) IN GENERAL.

This paragraph (b)(5) applies to basis adjustments under section 743(b) which result from exchanges in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest. For example, this paragraph applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies or to a partnership in a transaction to which section 721(a) applies.

(ii) ALLOCATIONS BETWEEN CLASSES OF PROPERTY.
If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5). If there is an increase in basis to be allocated to partnership assets, such increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under section 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. Where, under the preceding sentence, an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase shall be allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class. If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under section 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Where, under the preceding sentence, a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss which would be allocated to the transferee from the sale of all assets in each class.

(iii) ALLOCATIONS WITHIN THE CLASSES --

(A) INCREASES.

If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

(B) DECREASES.

If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

(C) LIMITATION IN DECREASE OF BASIS.
Where, as the result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.

(D) CARRYOVER ADJUSTMENT.

Where a transferee's negative basis adjustment under section 743(b) cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(iv) EXAMPLES.

The provisions of this paragraph (b)(5) are illustrated by the following examples:

**EXAMPLE 1.** A is a member of partnership LTP, which has made an election under section 754. The three partners in LTP have equal interests in capital and profits. Solely in exchange for a partnership interest in UTP, A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its partnership interest ($5,000) equals its share of inside basis (also $5,000). Under section 723, UTP's basis in its interest in LTP is $5,000. LTP's only two assets on the date of contribution are inventory with a basis of $5,000 and a fair market value of $7,500, and a nondepreciable capital asset with a basis of $10,000 and a fair market value of $7,500. The amount of the basis adjustment under section 743(b) to partnership property is $0 ($5,000, UTP's basis in its interest in LTP, minus $5,000, UTP's share of LTP's basis in partnership assets). Because UTP acquired its interest in LTP in a transferred basis exchange, and the total amount of the basis adjustment under section 743(b) is zero, UTP receives no special basis adjustments under section 743(b) with respect to the partnership property of LTP.

**EXAMPLE 2.** (i) A purchases a partnership interest in LTP at a time when an election under section 754 is not in effect. The three partners in LTP have equal interests in capital and profits. During a later year for which LTP has an election under section 754 in effect, and in a transaction that is unrelated to A's purchase of the LTP interest, A contributes its interest in LTP to UTP in a transaction described in section 721 (solely in exchange for a partnership interest in UTP). At the time of the transfer, A's adjusted basis in its interest in LTP is $20,433. Under section 721, A recognizes no gain or loss as a result of the contribution of its partnership interest to UTP. Under section 723, UTP's basis in its partnership interest in LTP is $20,433. The balance sheet of LTP on the date of the contribution shows the following:
### Assets

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$20,000</td>
<td>$21,000</td>
</tr>
<tr>
<td>Nondepreciable capital asset</td>
<td>$20,000</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$55,000</strong></td>
<td><strong>$76,000</strong></td>
</tr>
</tbody>
</table>

### Liabilities and Capital

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>$10,000</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$15,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>B</td>
<td>$15,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>C</td>
<td>$15,000</td>
<td>$22,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$55,000</strong></td>
<td><strong>$76,000</strong></td>
</tr>
</tbody>
</table>

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of UTP's interest in LTP and UTP's share of the adjusted basis to LTP of partnership property. UTP's interest in the previously taxed capital of LTP is $15,000 ($22,000, the amount of cash UTP would receive if LTP liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to UTP from the hypothetical transaction). UTP's share of the adjusted basis to LTP of partnership property is $18,333 ($15,000 share of previously taxed capital, plus $3,333 share of LTP's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $2,100 ($20,433 minus $18,333).

(iii) The total amount of gain that would be allocated to UTP from the hypothetical sale of capital gain property is $6,666.67 (one-third of the excess of the fair market value of LTP's nondepreciable capital asset, $40,000, over its basis, $20,000). The total amount of gain that would be allocated to UTP from the hypothetical sale of ordinary income property is $333.33 (one-third of the excess of the fair market value of LTP's inventory, $21,000, over its basis, $20,000). Under paragraph (b)(5), LTP must allocate $2,000 ($6,666.67 divided by $7,000 times $2,100) of UTP's basis adjustment to the nondepreciable capital asset. LTP must allocate $100 ($333.33 divided by $7,000 times $2,100) of UTP's basis adjustment to the inventory.

(c) ADJUSTMENTS UNDER SECTION 734(B) --

1) ALLOCATIONS BETWEEN CLASSES OF PROPERTY --

   (i) GENERAL RULE.

   Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property.
with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

(ii) SPECIAL RULE.

Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.

(2) ALLOCATIONS WITHIN THE CLASSES --

(i) INCREASES.

If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

(ii) DECREASES.

If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property’s unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).

(3) LIMITATION IN DECREASE OF BASIS.

Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property is reduced to zero (but not below zero).

(4) CARRYOVER ADJUSTMENT.

Where, in the case of a distribution, an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no
property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(5) EXAMPLE.

The following example illustrates this paragraph (c):

EXAMPLE. (i) A, B, and C form equal partnership PRS. A contributes $50,000 and Asset 1, capital gain property with a fair market value of $50,000 and an adjusted tax basis of $25,000. B and C each contributes $100,000. PRS uses the cash to purchase Assets 2, 3, 4, 5, and 6. Assets 4, 5, and 6 are the only assets held by the partnership which are subject to section 751. The partnership has an election in effect under section 754. After seven years, the adjusted basis and fair market value of PRS’s assets are as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 1</td>
<td>$25,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Asset 2</td>
<td>$100,000</td>
<td>$117,500</td>
</tr>
<tr>
<td>Asset 3</td>
<td>$50,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Ordinary Income Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 4</td>
<td>$40,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Asset 5</td>
<td>$50,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Asset 6</td>
<td>$10,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>Total</td>
<td>$274,000</td>
<td>$360,000</td>
</tr>
</tbody>
</table>

(ii) ALLOCATION BETWEEN CLASSES.

Assume that PRS distributes Assets 3 and 5 to A in complete liquidation of A’s interest in the partnership. A’s basis in the partnership interest was $75,000. The partnership’s basis in Assets 3 and 5 was $50,000 each. A’s $75,000 basis in its partnership interest is allocated between Assets 3 and 5 under sections 732(b) and (c). A will, therefore, have a basis of $25,000 in Asset 3 (capital gain property), and a basis of $50,000 in Asset 5 (section 751 property). The distribution results in a $25,000 increase in the basis of capital gain property. There is no change in the basis of ordinary income property.

(iii) ALLOCATION WITHIN CLASS.

The amount of the basis increase to capital gain property is $25,000 and must be allocated among the remaining capital gain assets in proportion to the difference between the fair market value and basis of each. The fair market value of Asset 1 exceeds its basis by $50,000. The fair market value of Asset 2 exceeds its basis by $17,500. Therefore, the basis of Asset 1 will be increased by $18,519 ($25,000, multiplied by $50,000, divided by $67,500), and the basis of Asset 2 will be increased by $6,481 ($25,000 multiplied by $17,500, divided by $67,500).
(d) EFFECTIVE DATE.

This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

Sec. 1.755-2T Coordination of sections 755 and 1060 (Temporary).

(a) Coordination with section 1060--

(1) In general.

If there is a basis adjustment to which this section applies--

(i) The fair market value of each item of partnership property must be determined under this section; and

(ii) The rules of section 1.755-1 must be applied using the values so determined.

(2) Application of this section.

This section applies to any basis adjustment made under section 743(b) (relating to certain transfers of interests in a partnership) or section 732(d) (relating to certain partnership distributions), if assets of the partnership constitute a trade or business for purposes of section 1060(c).

(b) Determining the fair market value of partnership property--

(1) Property other than that in the nature of goodwill or going concern value.

For purposes of this section, the fair market value of each item of partnership property (other than property in the nature of goodwill or going concern value) shall be determined on the basis of all the facts and circumstances.

(2) Property in the nature of goodwill or going concern value.

For purposes of paragraph (a) of this section, the fair market value of partnership property in the nature of goodwill or going concern value (referred to hereinafter in this section as goodwill) shall be deemed to equal the amount (not below zero) which if assigned to such property would result in a liquidating distribution to the transferee partner equal to such partner’s basis for the transferred partnership interest immediately after the transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) if--

(i) All partnership property were sold immediately after such transfer for an amount equal to the fair market value of such property (as determined under this section), and

(ii) The proceeds of that sale were, after the payment of all partnership liabilities (within the meaning of section 752 and the regulations thereunder), distributed to the partners.
(c) Cross-reference.

See sections 1.732-1(d)(3) and 1.743-1(b)(3) for rules requiring a transferee partner to attach a statement to such partner's return showing the computation of the special basis adjustment and the partnership properties to which the adjustment is allocated under section 755.

(d) Effective date.

This section applies to any basis adjustment under section 743(b) made as a result of any transfer of a partnership interest made after May 6, 1986, unless such transfer is made pursuant to a binding contract that was in effect on May 6, 1986, and at all times thereafter prior to such transfer. However, the requirements of this section shall be deemed to be satisfied with respect to any transfer made on or before July 15, 1988, if the amount of any basis adjustment under section 743(b) or section 732(d) made as a result of such transfer that is allocated to each item of partnership property (other than goodwill) does not exceed the amount equal to the difference between the transferee partner's share of the partnership basis of such property and such partner's share of the fair market value of such property.

(e) Example.

The provisions of this section may be illustrated by the following example which assumes that the assets of the partnership constitute a trade or business under section 1060 and that the partnership has an election in effect under section 754 at the time of the sale of the partnership interest.

**Example (1).** A is a member of partnership ABC. ABC has three assets: a building with a fair market value of $2,000,000, equipment with a fair market value of $800,000 and goodwill. ABC has no liabilities. A has a one-third interest in partnership capital and profits. A sells his partnership interest to D for $1,000,000. Under paragraph (b)(2) of this section, the fair market value of goodwill is deemed to equal the value that must be assigned to goodwill in order for the partnership to distribute $1,000,000 to D if it were to sell all of its property at fair market value (in the case of goodwill, its assigned value) and completely liquidate after D's purchase of A's partnership interest. In order for D, a one-third partner, to receive a liquidation distribution of $1,000,000, the partnership would have to sell all partnership property for a total of $3,000,000. The fair market value of partnership property other than goodwill is $2,800,000. Therefore, goodwill must be assigned a value of $200,000 ($3,000,000 - $2,800,000) in order for D to receive a liquidating distribution of $1,000,000. Accordingly, D's section 743(b) basis adjustment must be allocated under section 1.755-1 using a fair market value of $200,000 for goodwill.

[T.D. 8215, 53 FR 27044, July 18, 1988]

**Sec. 1.761-1 Terms defined.**

(a) Partnership.
The term partnership means a partnership as determined under sections 301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

(b) Partner.

The term "partner" means a member of a partnership.

(c) Partnership agreement.

For the purposes of Subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) Liquidation of partner's interest.

The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of section 1.731-1.

(e) Distribution of partnership interest.

For purposes of section 708(b)(1)(B) and section 1.708-1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. However, the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of section 743. This paragraph (e) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (e) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (e) to the termination in a consistent manner.
Sec. 1.761-2 Exclusion of certain unincorporated organizations from the application of all or part of subchapter K of chapter 1 of the Internal Revenue Code.

(a) Exclusion of eligible unincorporated organizations--

(1) In general.

Under conditions set forth in this section, an unincorporated organization described in subparagraph (2) or (3) of this paragraph may be excluded from the application of all or a part of the provisions of Subchapter K of Chapter 1 of the Code. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(2) Investing partnership.

Where the participants in the joint purchase, retention, sale, or exchange of investment property:

(i) Own the property as co-owners,

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of Subchapter K under the rules set forth in paragraph (b) of this section.

(3) Operating agreements.

Where the participants in the joint production, extraction, or use of property:

(i) Own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights, and
(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year, then such group may be excluded from the application of the provisions of Subchapter K under the rules set forth in paragraph (b) of this section. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization. In addition, except as provided in paragraph (d)(2)(i) of this section, this paragraph (a)(3) does not apply to any unincorporated organization that produces natural gas under a joint operating agreement, unless all members of the unincorporated organization comply with paragraph (d) of this section.

(b) Complete exclusion from Subchapter K--

(1) Time for making election for exclusion.

Any unincorporated organization described in subparagraph (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of Subchapter K must make the election provided in section 761(a) not later than the time prescribed by paragraph (e) of section 1.6031-1 (including extensions thereof) for filing the partnership return for the first taxable year for which exclusion from Subchapter K is desired. Notwithstanding the prior sentence such organization may be deemed to have made the election in the manner prescribed in subparagraph (2)(ii) of this paragraph.

(2) Method of making election.

(i) Except as provided in subdivision (ii) of this subparagraph, any unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of Subchapter K must make the election provided in section 761(a) in a statement attached to, or incorporated in, a properly executed partnership return, Form 1065, which shall contain the information required in this subdivision. Such return shall be filed with the internal revenue officer with whom a partnership return, Form 1065, would be required to be filed if no election were made. Where, for the purpose of determining such officer, it is necessary to determine the internal revenue district (or service center serving such district) in which the electing organization has its principal office or place of business, the principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. The partnership return must be filed not later than the time prescribed by paragraph (e) of section 1.6031-1 (including extensions thereof) for filing the partnership return with respect to the first taxable year for which exclusion from Subchapter K is desired. Such partnership return shall contain, in lieu of the information required by Form 1065 and by the
instructions relating thereto, only the name or other identification and the address of the organization together with information on the return, or in the statement attached to the return, showing the names, addresses, and identification numbers of all the members of the organization; a statement that the organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section; a statement that all of the members of the organization elect that it be excluded from all of Subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained).

(ii) If an unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section does not make the election provided in section 761(a) in the manner prescribed by subdivision (i) of this subparagraph, it shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of Subchapter K beginning with the first taxable year of the organization. Although the following facts are not exclusive, either one of such facts may indicate the requisite intent:

(a) At the time of the formation of the organization there is an agreement among the members that the organization be excluded from Subchapter K beginning with the first taxable year of the organization, or

(b) The members of the organization owning substantially all of the capital interests report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from Subchapter K beginning with the first taxable year of the organization.

(3) Effect of election--

(i) In general.

An election under this section to be excluded will be effective unless within 90 days after the formation of the organization (or by October 15, 1956, whichever is later) any member of the organization notifies the Commissioner that the member desires Subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such election is irrevocable as long as the organization remains qualified under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, or unless approval of revocation of the election is secured from the Commissioner. Application for permission to revoke the election must be submitted to the Commissioner of Internal Revenue, Attention: T:I, Washington, D.C. 20224, no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.

(ii) Special rule.
Notwithstanding subdivision (i) of this subparagraph, an election deemed made pursuant to subparagraph (2)(ii) of this paragraph will not be effective in the case of an organization which had a taxable year ending on or before November 30, 1972, if any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such notification to the Commissioner must be made on or before January 2, 1973 and must include the names and addresses of all of the members of the organization.

(c) Partial exclusion from Subchapter K.

An unincorporated organization which wishes to be excluded from only certain sections of Subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of Subchapter K. The request shall set forth the sections of Subchapter K from which exclusion is sought and shall state that such organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(d) Rules for gas producers that produce natural gas under joint operating agreements --

(1) Joint operating agreements and gas balancing.

Co-owners of a property producing natural gas enter into a joint operating agreement (JOA) to define the rights and obligations of each co-producer of the gas in place. The JOA determines, among other things, each co-producer’s proportionate share of the natural gas as it is produced from the reservoir, together with the associated production expenses. A gas imbalance arises when a co-producer does not take its proportionate share of current gas production under the JOA (underproducer) and another co-producer takes more than its proportionate share of current production (overproducer). The co-producers often enter into a gas balancing agreement (GBA) as an addendum to their JOA to establish their rights and obligations when a gas imbalance arises. A GBA typically allows the overproducer to take the amount of the gas imbalance (overproduced gas) and entitles the underproducer to recoup the overproduced gas either from the volume of the gas remaining in the reservoir or by a cash balancing payment.

(2) Permissible gas balancing methods --

(i) General requirement.

All co-producers of natural gas operating under the same JOA must use the cumulative gas balancing method, as described in paragraph (d)(3) of this section, unless they use the annual gas balancing method described in
paragraph (d)(4) of this section. A co-producer’s failure to comply with the provisions of this paragraph (d)(2)(i) generally constitutes the use of an impermissible method of accounting, requiring a change to a permissible method under section 1.446-1(e)(3) with any terms and conditions as may be imposed by the Commissioner. The co-producers’ election to be excluded from all or part of subchapter K will not be revoked, unless the Commissioner determines that there was willful failure to comply with the requirements of this paragraph (d)(2)(i).

(ii) Change in method of accounting; adoption of method of accounting --

(A) In general.

The annual gas balancing method and the cumulative gas balancing method are methods of accounting. Accordingly, a change to or from either of these methods is a change in method of accounting that requires the consent of the Commissioner. See section 446(e) and section 1.446-1(e). For purposes of this section, each JOA is treated as a separate trade or business. Paragraph (d)(2)(ii)(B) of this section provides rules for adopting either permissible method of accounting. Paragraph (d)(2)(ii)(C) of this section provides rules on the timing of required changes to either permissible method during the transitional period, and paragraph (d)(5) of this section contains the procedural provisions for making a change in method of accounting required in paragraph (d)(2)(ii)(C) of this section.

(B) Adoption of method of accounting.

A co-producer must adopt a permissible method for each JOA entered into on or after the start of the co-producer’s first taxable year beginning after December 31, 1994 (or, in the case of the use of the annual gas balancing method by co-producers not having the same taxable year, the start of the first taxable year beginning after December 31, 1994, of the co-producer whose taxable year begins latest in the calendar year). If a co-producer is adopting the cumulative method, the co-producer may adopt the method by using the method on its timely filed return for the taxable year of adoption. A co-producer may adopt the annual gas balancing method with the permission of the Commissioner under guidelines set forth in paragraph (d)(4)(ii) of this section.

(C) Required change in method of accounting for certain joint operating agreements.

This paragraph (d)(2)(ii)(C) applies to certain JOAs entered into prior to 1996. Except in the case of a part-year change in method of accounting or in the case of the cessation of a JOA (both of which are described in this paragraph (d)(2)(ii)(C)), for each JOA entered into prior to a co-producer’s first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year, the co-producer must change its method of accounting for sales of gas and its treatment of certain related deductions and credits to a permissible method as of the start of its first taxable year beginning after December 31, 1994. In the
case of a JOA of co-producers that do not all have the same taxable year and that choose the annual gas balancing method, if the JOA is entered into prior to the first taxable year beginning after December 31, 1994 of the co-producer whose taxable year begins latest in the calendar year and the JOA is in effect as of January 1, 1996, a change to the annual gas balancing method by each co-producer under that JOA is made as of January 1, 1996 (part-year change in method of accounting). If the co-producers would have made a part-year change to the annual gas balancing method but for the fact that their JOA ceased to be in effect before January 1, 1996 (cessation of a JOA), the co-producers do not change their method of accounting with respect to the JOA. Rather, for their taxable years in which the JOA ceases to be in effect, the co-producers use their current method of accounting with respect to that JOA.

(3) Cumulative gas balancing method --

(i) In general.

The cumulative gas balancing method (cumulative method), solely for purposes of reporting income from gas sales and certain related deductions and credits, treats each co-producer under the same JOA as the sole owner of its percentage share of the total gas in the reservoir and disregards the ownership arrangement described in the JOA for gas as it is produced from the reservoir. Each co-producer is considered to be taking only its share of the total gas in the reservoir as long as the gas remaining in the reservoir is sufficient to satisfy the ownership rights of the co-producers in their percentage shares of the total gas in the reservoir. After a co-producer has taken its entire share of the total gas in the reservoir, any additional gas taken by that co-producer (taking co-producer) is treated as having been taken from its other co-producers' shares of the total gas in the reservoir. The effect of being treated as a taking co-producer under the cumulative method is that the taking co-producer generally may not claim an allowance for depletion and a production credit on its sales of its other co-producers' percentage shares of the total gas in the reservoir.

(ii) Requirements --

(A) Reporting of income from sales of gas.

Under the cumulative method, each co-producer must include in gross income under its overall method of accounting the amount of its sales from all gas produced from the reservoir, including sales of gas taken from another co-producer's share of the gas in the reservoir.

(B) Reporting of deduction of taking co-producer.

A taking co-producer deducts the amount of a payment (in cash or property, other than gas produced under the JOA) made to another co-producer for sales of that co-producer's gas, but only for the taxable year in which the payment is made. Thus, an accrual method taking co-producer is not permitted a deduction for any obligation it has to pay another co-producer for sales of that co-producer's gas until a payment is made.
made. See paragraph (d)(3)(iii)(B) of this section for a rule requiring a reduction of the amount of the deduction described in this paragraph (d)(3)(ii)(B) if the taking co-producer had mistakenly claimed a depletion deduction relating to those sales.

(C) Reporting of income by other co-producers.

Any co-producer that is entitled to receive a payment from a taking co-producer must include the amount of the payment in gross income as proceeds from the sale of its gas only for the taxable year that the payment is actually received, regardless of its overall method of accounting.

(D) Reporting of production expenses.

Each co-producer deducts its proportionate share of production expenses, as provided in the JOA, under its regular method of accounting for the expenses.

(iii) Special rules for production credits and depletion deductions under the cumulative method --

(A) In general.

Under the cumulative method, a co-producer's depletion allowance and production credit for a taxable year are based on its income from gas sales and production of gas from its percentage share of the total gas in the reservoir, and are not based on its current proportionate share of income and production as determined under the JOA. Thus, in general, a taking co-producer is not allowed a production credit or an allowance for depletion on its sales of gas in excess of its percentage share of the total gas in the reservoir. However, the Service will not disallow depletion deductions or production credits claimed by a taking co-producer on the gas of other co-producers if the taking co-producer had a reasonable but mistaken belief that the deductions or credits were claimed with respect to the taking co-producer's percentage share of total gas in the reservoir and the taking co-producer makes the appropriate reductions and additions to tax required in paragraphs (d)(3)(iii)(B) and (d)(3)(iii)(C) of this section. The reasonableness of the mistaken belief is determined at the time of filing the return claiming the deductions or credits. A co-producer receiving a payment for sales of its gas from a taking co-producer claims a production credit and an allowance for depletion relating to those sales only for the taxable year in which the amount of the payment is included in its gross income.

(B) Reduction of taking co-producer's payment deduction for depletion claimed on another co-producer's gas.

If a taking co-producer claims an allowance for depletion on another co-producer's gas, the taking co-producer must reduce its deduction claimed in a later year for making a payment to the other co-producer for sales of that co-producer's gas by the amount of any percentage depletion deduction allowed on the gas sales to which the payment
relates. If the percentage limitation of section 613A(d)(1) applied to disallow a depletion deduction for a previous year, the taking co-producer must reduce the amount of any carried over depletion deduction allowable in the year of the payment or in a future year by the portion of the carried over depletion deduction, if any, that relates to another co-producer's gas.

(C) Addition to tax of taking co-producer for production credit claimed on another co-producer's gas.

If a taking co-producer claims a production credit on another co-producer's gas, the taking co-producer must add to its tax for the taxable year that it makes a payment to the other co-producer for sales of that co-producer's gas any production credit allowed in an earlier taxable year on the gas sales to which the payment relates, but only to the extent the credit allowed actually reduced the taking co-producer's tax in any earlier year. The taking co-producer also must reduce the amount of its minimum tax credit allowable by reason of section 53(d)(1)(B)(iii) in the year of the payment or in a future year by the portion of the credit, if any, that relates to another co-producer's gas.

(iv) Anti-abuse rule.

If the Commissioner determines that co-producers using the cumulative method have arranged or altered their taking of production for a taxable year with a principal purpose of shifting the income, deductions, or credits relating to that production to avoid tax, the co-producers' election to be excluded from all or part of subchapter K will be revoked for that year and for subsequent years. In determining that a principal purpose was to avoid tax, the Commissioner will examine all the facts and circumstances surrounding the use of the cumulative method by the co-producers. See Examples 3 and 4 of paragraph (d)(6) of this section.

(4) Annual gas balancing method --

(i) In general.

The annual gas balancing method (annual method) takes into account each co-producer's ownership rights and obligations, as described in the JOA, with respect to the co-producer's current proportionate share of gas as it is produced from the reservoir. Under the annual method, gas imbalances relating to a JOA must be eliminated annually through a balancing payment, which may be in the form of cash, gas produced under the same JOA, or other property. If all the co-producers under a JOA have the same taxable year, any gas imbalance remaining at the end of a taxable year must be eliminated by a balancing payment from the overproducer to the underproducer by the due date of the overproducer's tax return for that taxable year (including extensions). If all the co-producers under a JOA do not have the same taxable year, any gas imbalance remaining at the end of a calendar year must be eliminated by a balancing payment from the overproducer to the underproducer by September 15 of the following calendar year. The annual method may be used only if the Commissioner's
permission is obtained. Paragraph (d)(4)(ii) of this section provides guidelines for applying for this permission. The annual method is not available for a JOA with respect to which any co-producer made an election under paragraph (d)(5)(i)(B)(3) of this section (to take an aggregate section 481(a) adjustment for all JOAs of a co-producer into account in the year of change).

(ii) Obtaining the commissioner's permission to use the annual method.

A request for the Commissioner's permission to adopt the annual method for a new JOA must be in writing and must set forth the names of all the co-producers under the JOA and the respective taxable year of adoption. See paragraphs (d)(2)(ii) and (d)(5)(ii) of this section for the rules for a change in method of accounting to the annual method. In addition, the request must contain an explanation of how the co-producers will report income from gas sales, the making or receiving of a balancing payment, production expenses, depletion deductions, and production credits. Permission will be granted under appropriate conditions, including, but not limited to, an agreement in writing by all co-producers to use the annual method and to eliminate any gas imbalances annually in accordance with paragraph (d)(4)(i) of this section.

(5) Transitional rules for making a change in method of accounting required in paragraph (d)(2)(ii)(C) of this section --

(i) Change in method of accounting to the cumulative method --

(A) Automatic consent to change in method of accounting to the cumulative method.

A co-producer changing to the cumulative method for any JOA entered into prior to its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year is granted the consent of the Commissioner to change its method of accounting with respect to each JOA to the cumulative method, provided the co-producer --

(1) Makes the change on its timely filed return for its first taxable year beginning after December 31, 1994;

(2) Attaches a completed and signed Form 3115 to the co-producer's tax return for the year of change, stating that, pursuant to section 1.761-2(d)(2)(ii) of the regulations, the co-producer is changing its method of accounting for sales of gas and its treatment of certain related deductions and credits under each JOA to the cumulative method;

(3) In the case of a co-producer making an election under paragraph (d)(5)(i)(B)(3) of this section to take the aggregate section 481(a) adjustment into account in the year of change, attaches the statement described in paragraph (d)(5)(i)(B)(3)(ii) of this section; and

(4) In the case of a co-producer not making an election under paragraph (d)(5)(i)(B)(3) of this section, attaches a list of each JOA
with respect to which there is a section 481(a) adjustment computed in accordance with paragraph (d)(5)(i)(B)(2)(i) of this section.

(B) Section 481(a) adjustment --

(1) Application of section 481(a).

A change in method of accounting to the cumulative method under the automatic consent procedure in paragraph (d)(5)(i)(A) of this section is a change in method of accounting to which the provisions of section 481(a) apply. Thus, a section 481(a) adjustment must be taken into account in the manner provided by this paragraph (d)(5)(i)(B) to prevent the omission or duplication of income. Paragraph (d)(5)(i)(B)(2) of this section provides the general rules for computing the amount of the section 481(a) adjustment of a co-producer relating to a particular JOA and for taking the section 481(a) adjustment into account. Paragraph (d)(5)(i)(B)(3) of this section provides rules for electing to take a co-producer's section 481(a) adjustment computed on an aggregate basis for all JOAs into account in the year of change. Paragraph (d)(5)(i)(C) of this section provides rules to coordinate the taking of a depletion deduction or a production credit with the inclusion of a section 481(a) adjustment arising from a change in method of accounting to the cumulative method under this paragraph (d)(5)(i).

(2) Computation of the section 481(a) adjustment relating to a joint operating agreement --

(i) In general.

The section 481(a) adjustment of a co-producer relating to a JOA is computed as of the first day of the co-producer's year of change and is equal to the difference between the amount of income reported under the co-producer's former method of accounting for all taxable years prior to the year of change and the amount of income that would have been reported if the co-producer's new method had been used in all those taxable years.

(ii) Section 481(a) adjustment period.

Except to the extent that paragraph (d)(5)(i)(B)(3) of this section applies, a co-producer's section 481(a) adjustment relating to a JOA, whether positive or negative, is taken into account in computing taxable income ratably over the 6-taxable-year period beginning with the year of change (the section 481(a) adjustment period). If the co-producer has been in existence less than 6 taxable years, the adjustment is taken into account over the number of years the co-producer has been in existence. If the co-producer ceases to engage in the trade or business that gave rise to the section 481(a) adjustment at any time during the section 481(a) adjustment period, the entire remaining balance of the section 481(a) adjustment relating to that trade or business must be taken into account in the year of the cessation. For
purposes of this paragraph (d)(5)(i)(B)(2)(ii), production under each JOA is treated as a separate trade or business. The determination as to whether the co-producer ceases to engage in its trade or business is to be made under the principles of section 1.446-1(e)(3)(ii) and its underlying administrative procedures. For example, the permanent cessation of production under a co-producer's JOA constitutes the cessation of a trade or business of the co-producer. Accordingly, for the year that production under a JOA permanently ceases, the remaining balance of the section 481(a) adjustment relating to the JOA must be taken into account.

(3) Election to take aggregate section 481(a) adjustment for all joint operating agreements into account in the year of change --

(i) In general.

A co-producer may elect to take into account its section 481(a) adjustment, computed on an aggregate basis for all of its JOAs, whether negative or positive, in the year of change, provided the co-producer uses the cumulative method for all of its JOAs entered into prior to its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year. The aggregate section 481(a) adjustment of a co-producer is equal to the difference between the amount of income reported under the co-producer's former method of accounting for all taxable years prior to the year of change and the amount of income that would have been reported if the co-producer's new method had been used in all of those taxable years for all JOAs for which the co-producer changes its method of accounting. An election made under this paragraph (d)(5)(i)(B)(3) is irrevocable. If any person who, together with another person, would be treated as a single taxpayer under section 41(f)(1)(A) or (B) makes an election under this paragraph (d)(5)(i)(B)(3), all persons within that single taxpayer group will be treated as if they had made an election under this paragraph (d)(5)(i)(B)(3) and, as such, will be irrevocably bound by that election. If a co-producer does not make an election under this paragraph, each JOA entered into prior to the start of its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year must be accounted for separately in computing the section 481(a) adjustment and taxable income of the co-producer for any year to which this paragraph (d) applies.

(ii) Time and manner for making the election.

An election under this paragraph (d)(5)(i)(B)(3) is made by attaching a statement to the co-producer's timely filed return for its year of change indicating that the co-producer is electing under section 1.761-2(d)(5)(i)(B)(3) to take its aggregate section 481(a) adjustment into account in the year of change.
(C) Treatment of section 481(a) adjustment as a sale for purposes of computing a production credit and as gross income from the property for purposes of depletion deductions.

Any positive section 481(a) adjustment arising as a result of a change in method of accounting for gas imbalances under this paragraph (d)(5)(i) and taken into account in computing taxable income under paragraph (d)(5)(i)(B) of this section is considered a sale by the taxpayer for purposes of computing any production credit in the year that the adjustment is taken into account. Similarly, the positive section 481(a) adjustment is considered gross income from the property and taxable income from the property for purposes of computing depletion deductions in the year the adjustment is taken into account. Sales amounts used in computing any production credit in any year in which a negative section 481(a) adjustment is taken into account in computing taxable income under paragraph (d)(5)(i)(B) of this section must be reduced by the amount of the negative section 481(a) adjustment taken into account in that year. Similarly, gross income from the property and taxable income from the property used in computing any depletion deduction in any year in which the negative section 481(a) adjustment is taken into account must be reduced by the amount of the negative adjustment. For these purposes, any taxpayer that makes an aggregate section 481(a) adjustment election under paragraph (d)(5)(i)(B) of this section must allocate the adjustment among its properties in any reasonable manner that prevents a duplication or omission of depletion deductions.

(ii) Change in method of accounting to the annual method --

(A) In general.

A co-producer changing to the annual method in accordance with paragraph (d)(2)(ii) of this section must request a change under section 1.446-1(e)(3) and will be subject to any terms and conditions as may be imposed by the Commissioner.

(B) Section 481(a) adjustment.

A change in method of accounting to the annual method is a change in method of accounting to which the provisions of section 481(a) apply. Thus, a section 481(a) adjustment must be taken into account to prevent the omission or duplication of income. If all the co-producers under a JOA have the same taxable year, the section 481(a) adjustment involved in a change to the annual method by a co-producer relating to the JOA is computed as of the first day of the co-producer’s year of change. If the co-producers under a JOA do not all have the same taxable year (that is, in the case of a part-year change described in paragraph (d)(2)(ii)(C) of this section), the change in method of accounting occurs on January 1, 1996, and the section 481(a) adjustment is computed on that date.

(iii) Untimely change in method of accounting to comply with this section.

Unless a co-producer required by this section to change its method of accounting complies with the provisions of this paragraph (d)(5) for its first
applicable taxable year within the time prescribed by this paragraph (d)(5), the co-producer must take the section 481(a) adjustment into account under the provisions of any applicable administrative procedure that is prescribed by the Commissioner specifically for purposes of complying with this section. Absent such an administrative procedure, a co-producer must request a change under section 1.446-1(e)(3) and will be subject to any terms and conditions as may be imposed by the Commissioner.

(6) Examples.

The following examples illustrate the application of the cumulative method described in paragraph (d)(3) of this section.

Example 1. Operation of the cumulative method. (i) L, a corporation using the cash receipts and disbursements method of accounting, and M, a corporation using an accrual method, file returns on a calendar year basis. On January 1, 1995, L and M enter into a JOA to produce natural gas as an unincorporated organization from a reservoir located in State Y. The JOA allocates reservoir production 60 percent to L and 40 percent to M. L and M enter into a GBA as an addendum to the JOA. L and M agree to use the cumulative method to account for gas sales from the reservoir and elect under section 761(a) and this section to exclude the organization from the application of subchapter K. Production from the reservoir is eligible for the section 29 credit for producing fuel from a nonconventional source. L and M produce and sell the following amounts of natural gas (in mmcf) until 2000 during which year production from the reservoir ceases:

<table>
<thead>
<tr>
<th>Year</th>
<th>L</th>
<th>M</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>720</td>
<td>240</td>
</tr>
<tr>
<td>1996</td>
<td>480</td>
<td>60</td>
</tr>
<tr>
<td>1997</td>
<td>600</td>
<td>120</td>
</tr>
<tr>
<td>1998</td>
<td>-0-</td>
<td>160</td>
</tr>
<tr>
<td>1999</td>
<td>-0-</td>
<td>80</td>
</tr>
<tr>
<td>2000</td>
<td>-0-</td>
<td>40</td>
</tr>
</tbody>
</table>

(ii) By the end of 1996, neither L nor M has fully produced its percentage share of the total gas in the reservoir. In 1997, L produces a total of 600 mmcf of gas at the rate of 50 mmcf per month. Prior to filing its return for 1997, L determines that it fully produced its percentage share of gas in the reservoir as of June 30, 1997. Pursuant to the GBA executed by L and M, L pays M at the end of 2000 for the 300 mmcf of M's gas (as determined under the cumulative method) that L sold in the last half of 1997.

(iii) For 1995, L and M must include in their gross income the amounts relating to gas sales of 720 mmcf and 240 mmcf, respectively. For 1996, L and M must include the amounts relating to gas sales of 480 mmcf and 60 mmcf, respectively. For both 1995 and 1996, L and M compute an allowance for depletion and a section 29 credit based upon gas taken and sold by each from the reservoir for each taxable year.

(iv) For 1997, L and M must include in gross income the amounts relating to their gas sales of 600 mmcf and 120 mmcf, respectively. Under paragraph (d)(3)(ii)(A) of this section, L computes an allowance for depletion and the section 29 credit based only on production from L's proportionate share of gas in the reservoir (that is, based on L's production through June 30, 1997). Accordingly, for 1997, L claims depletion and the section 29 credit only with
respect to 300 mmcf of gas (50 mmcf per month x 6 months). For 1997, because M has not fully produced from its percentage share of the total gas in the reservoir as of the end of 1997, M claims depletion and the section 29 credit on the 120 mmcf that M produced in 1997.

(v) In 1998 and 1999, M must include in gross income the amounts relating to M's sales of gas, that is, 160 mmcf for 1998 and 80 mmcf for 1999. For 2000, M must include in gross income the amount relating to sales of 340 mmcf of gas, which consists of its own sales of 40 mmcf plus the payment for 300 mmcf of gas that L made to M for having sold from M's share of the total gas in the reservoir during the last half of 1997. Because M produced from its percentage share of the total gas in the reservoir during 1998, 1999, and 2000, M claims a depletion deduction and a section 29 credit on its income and production for those years, that is, 160 mmcf for 1998, 80 mmcf for 1999, and 40 mmcf for 2000. Additionally, for 2000, M claims depletion and the section 29 credit relating to the payment that M received from L for the 300 mmcf of M's gas that L sold in the last half of 1997. Under paragraph (d)(3)(ii)(B) of this section, L's deduction for its payment to M for the 300 mmcf of M's gas that L sold in 1997 is allowable only for 2000.

Example 2. Adjustments under the cumulative method for depletion deductions and production credits that were claimed for sales in excess of a co-producer's percentage share of total gas in the reservoir. (i) L, a corporation using the cash receipts and disbursements method of accounting, and M, a corporation using an accrual method, file returns on a calendar year basis. On January 1, 1995, L and M enter into a JOA to produce natural gas as an unincorporated organization from a reservoir located in State Y. The JOA allocates reservoir production 60 percent to L and 40 percent to M. L and M enter into a GBA as an addendum to the JOA. L and M agree to use the cumulative method to account for gas sales from the reservoir and elect under section 761(a) and this section to exclude the organization from the application of subchapter K. Production from the reservoir is eligible for the section 29 credit for producing fuel from a nonconventional source. L and M produce and sell the following amounts of natural gas (in mmcf) until 2000 during which year production from the reservoir ceases:

<table>
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<tr>
<td>L</td>
<td>720</td>
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<td>600</td>
<td>60</td>
<td>60</td>
<td>-0-</td>
</tr>
<tr>
<td>M</td>
<td>240</td>
<td>60</td>
<td>120</td>
<td>60</td>
<td>60</td>
<td>40</td>
</tr>
</tbody>
</table>

(ii) In addition, L does not realize until December 31, 1999, that L fully produced its percentage share of the total gas in the reservoir as of June 30, 1997. At the time of filing its returns for 1997 and 1998, L reasonably believes that during 1997 and 1998, respectively, it did not fully produce its percentage share of the total gas in the reservoir. Thus, L claims depletion and the section 29 credit for its total sales of 600 mmcf in 1997 and 60 mmcf in 1998. Pursuant to the GBA executed by L and M, L pays M at the end of 2000 for the 420 mmcf of M's gas (as determined under the cumulative method) that L sold (300 mmcf in the last half of 1997 (assuming that production was at a rate of 50 mmcf per month), 60 mmcf in 1998, and 60 mmcf in 1999).
(iii) In 1997 and 1998, L and M include in gross income the amounts relating to their respective sales of gas, that is, for L 600 mmcf for 1997 and 60 mmcf for 1998, and for M 120 mmcf for 1997 and 60 mmcf for 1998.

(iv) For 1999, L must include in gross income the amount of its sales of 60 mmcf, but may not claim depletion or the section 29 credit on those sales. For 1999, M must include in gross income the amount of its sales of 60 mmcf and claims depletion and the section 29 credit with respect to those 60 mmcf.

(v) For 2000, M must include in gross income the amount relating to gas sales of 460 mmcf, that is, the amount of M's own gas sales of 40 mmcf and the amount of the payment received from L for the 420 mmcf of M's gas that L sold (consisting of 300 mmcf in 1997, 60 mmcf in 1998, and 60 mmcf in 1999). Under paragraph (d)(3)(iii)(A) of this section, M computes a depletion deduction and a production credit relating to the amount of M's actual gas sales for 2000 and the payment received from L, that is, relating to a total of 460 mmcf of gas (M's sales of 40 mmcf for 2000, plus L's payment for 420 mmcf of gas). Under paragraph (d)(3)(ii)(B) of this section, L's deduction for making its payment to M for 420 mmcf of gas is allowable only for 2000. Under paragraph (d)(3)(iii)(B) of this section, L must reduce its deduction by the amount of any percentage depletion deductions allowed on its sales of M's gas, that is, relating to 360 mmcf of gas (300 mmcf for 1997 and 60 mmcf for 1998). In addition, under paragraph (d)(3)(iii)(C) of this section, L must increase its tax for 2000 by the amount of any section 29 credit L claimed on its sales of M's gas, but only to the extent that the credit claimed actually reduced L's tax in any earlier year.

Example 3. Non-abusive altering of the taking of production for a taxable year.

(i) C and D enter into a JOA and a GBA on December 1, 1994, for gas production from a reservoir. The JOA allocates production at 50 percent to C and 50 percent to D. C and D agree in writing to use the cumulative method to account for gas sales. Additionally, C and D elect under section 761(a) and this section to exclude their organization from the application of subchapter K. C and D arrange to sell all their production under annually renewable contracts. In 1995, C and D each sell 480 mmcf of gas from the reservoir.

(ii) In November 1995, D is notified that its contract with its purchaser will not be renewed for 1996. D is unable to find a new purchaser for its gas for 1996. In December 1995, D notifies C that it will not be taking production from the reservoir in 1996. Pursuant to the GBA, C then contracts with its current gas purchaser to sell an additional 20 mmcf per month in 1996. Accordingly, C sells 720 mmcf in 1996 (60 mmcf per month x 12 months). Under the facts described in this example, a principal purpose of altering the taking of production is not to avoid tax. Accordingly, the co-producers' election under section 761(a) will not be revoked by reason of altering the taking of production.

Example 4. Abusive altering of the taking of production for a taxable year. The facts are the same as in Example 3(i). For 1996, C anticipates that C's regular tax (reduced by the credits allowable under sections 27 and 28) will not exceed C's tentative minimum tax. Accordingly, under section 29(b)(6), C's credit allowed under section 29(a) for sales of its gas will be zero. For 1997, C anticipates that its credit allowed under section 29(a) will not be limited by section 29(b)(6). On the other hand, D anticipates that any credit it may claim
under section 29(a) for 1996, even including a credit based on sales of C's share of current production under the JOA, will not be limited by section 29(b)(6). However, for 1997, D anticipates that its credit under section 29(a) will be limited by section 29(b)(6). On January 1, 1996, C and D agree that D will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1996 and that C will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1997. Under these facts, a principal purpose of altering the taking of production is to avoid tax. Accordingly, the co-producers' election under section 761(a) will be revoked for 1996 and for subsequent years.

(7) Effective date.

Except in the case of a part-year change to the annual method or the cessation of a JOA, both of which are described in paragraph (d)(2)(ii)(C) of this section, the provisions of this paragraph (d) apply to all taxable years beginning after December 31, 1994, of any producer that is a member of an unincorporated organization that produces natural gas under a JOA in effect on or after the start of the producer's first taxable year beginning after December 31, 1994. In the case of a part-year change, the provisions of this paragraph (d) apply on and after January 1, 1996. In the case of the cessation of a JOA, the co-producers use their current method of accounting with respect to that JOA until the JOA ceases to be in effect.

(e) Cross reference.

For requirements with respect to the filing of a return on Form 1065 by a partnership, see section 1.6031-1.