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>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Day 2 Adjustment</td>
<td>+2,000</td>
<td>+5,000</td>
<td>-2,000</td>
</tr>
<tr>
<td>Day 3 Adjustment</td>
<td>+3,000</td>
<td>-3,000</td>
<td>-2,000</td>
</tr>
<tr>
<td>Total</td>
<td>$105,000</td>
<td>$102,000</td>
<td>$96,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stock 1</th>
<th>Stock 2</th>
<th>Stock 3</th>
<th>Stock 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Day 2 Adjustment</td>
<td>+2,000</td>
<td>+5,000</td>
<td>-2,000</td>
</tr>
<tr>
<td>Day 3 Adjustment</td>
<td>+3,000</td>
<td>-3,000</td>
<td>-2,000</td>
</tr>
<tr>
<td>Total</td>
<td>$105,000</td>
<td>$102,000</td>
<td>$96,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>X and Y</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>Tax</td>
<td>Revaluation account</td>
</tr>
<tr>
<td>Opening Balance</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Day 2 Adjustment</td>
<td>$2,500</td>
<td>0</td>
</tr>
<tr>
<td>Day 3 Adjustment</td>
<td>-1,000</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$151,500</td>
<td>$150,000</td>
</tr>
<tr>
<td>Net Tax Loss-Stocks 2 &amp; 3</td>
<td>0</td>
<td>(333)</td>
</tr>
<tr>
<td>Closing Balance</td>
<td>$151,500</td>
<td>$149,667</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Z</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>Tax</td>
<td>Revaluation account</td>
</tr>
<tr>
<td>Opening Balance</td>
<td>$152,500</td>
<td>$152,500</td>
</tr>
<tr>
<td>Day 3 Adjustment</td>
<td>-1,000</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$151,500</td>
<td>$152,500</td>
</tr>
<tr>
<td>Net Tax Loss-Stocks 2 &amp; 3</td>
<td>0</td>
<td>(1,333)</td>
</tr>
<tr>
<td>Closing Balance</td>
<td>$151,500</td>
<td>$151,167</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/Applicability Dates. With the exception of paragraphs (a)(1), (a)(8)(ii), (a)(8)(iii), (a)(10), and (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to §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. Paragraph (a)(8)(ii) applies to installment obligations received by a partnership in exchange for section 704(c) property on or after November 24, 2003. Paragraph (a)(8)(iii) applies to property acquired on or after November 24, 2003, by a partnership pursuant to a contract that is section 704(c) property. Except as otherwise provided in §1.752–7(k), paragraphs (a)(8)(iv) and (a)(12) apply to §1.752–7 liability transfers, as defined in §1.752–7(b)(4), occurring on or after December 24, 2003. Paragraphs (a)(1) and (a)(10) of this section are applicable for taxable years beginning after June 9, 2010.


§ 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 §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 §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 on section 704(c) property. This paragraph (a)(4)(i) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a)(4)(i) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a)(4)(i) 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 §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)(B), and all partners are unrelated.

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 at the time of the distribution. B and C each contribute $30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in §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 loss $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 at the fair market value at the time of the distribution, A would have recognized $7,000 of gain under section 704(c)(1)(A) and §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, 1986, 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, non-depreciable 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 §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 $7,000 ($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, 1985, 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.

(ii) On December 31, 1988, Property A is distributed to B in a current distribution. 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); and

(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 §1.704–3 on a sale of the contributed property to
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an unrelated party immediately before the distribution.

(3) Section 708(b)(1)(B) terminations. 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 §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 (transferee partnership) of all of its assets and liabilities to a second partnership (transferor 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 §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 §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 §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.
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(d) Special rules—(1) Nonrecognition transactions, installment obligations, contributed contracts, and capitalized costs—

(i) 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 §1.704-3(a)(8). See §1.737-2(d)(3) for a similar rule in the context of section 737.

(ii)–(iii) [Reserved]

(iv) Capitalized costs. Property to which the cost of section 704(c) property is properly capitalized is treated as section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that such property is treated as section 704(c) property under §1.704-3(a)(8)(iv). See §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 that the property distributed is properly characterized as a disguised sale to the transferee partner. See §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 non-contributing 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 the built-in gain of the 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 §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 §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 that is part of the same distribution as the distributed section 704(c) property, see §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 §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 754(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 §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. 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 §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 §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 addi-
tion 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 ex-
ample. Unless otherwise specified,
partnership income equals partnership
expenses (other than depreciation de-
ductions 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 unre-
related.

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 Prop-
erty 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 de-
sire to distribute Property A to B in com-
plete liquidation of B’s interest in the part-
nership. If Property A were distributed at
that time, however, A would recognize $9,000
of gain under section 704(c)(1)(B), the dif-
ference 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 prin-
cipal purpose of avoiding such gain, the part-
ners 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 prop-
erty 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 con-
tribution of the property to the partnership.
The steps taken by the partnership on De-
cember 31, 1998, however, are the functional
equivalent of an actual distribution of Prop-
erty A to B in complete liquidation of B’s in-
terest in the partnership as of that date. Sec-
tion 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 arrange-
ments such as those in this Example I that
have the effect of a distribution of property
within five years of the date of its contribu-
tion to the partnership would effectively un-
dermine 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 dis-
tribution 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 in-
terest in partnership operations, the dis-
tribution 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 ex-
piration of the five-year period specified in
section 704(c)(1)(B) and this section. Defer-
ing 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 rec-
ognized 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 Prop-
erty 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 affili-
ated group and continue to control the man-
agement of Property A by virtue of their con-
trrolling 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 Prop-
erty 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 dis-
tributed to D in complete liquidation of D’s
interest in the partnership.

(iv) The distribution of Property A to D oc-
curred more than five years after the con-
tribution of the property to the partnership.
On these facts, however, a principal purpose
of the transaction was to minimize the pe-
riod of time that A would have to remain

§ 1.704–4
§ 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 705(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

(g) Effective dates. This section applies to distributions by a partnership to a partner on or after January 9, 1995, except that paragraph (d)(1)(iv) applies to distributions by a partnership to a partner on or after June 24, 2003.


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