

the term *noncompensatory option* means an option (as defined in paragraph (g)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(g) *Definitions.* The following definitions apply for the purposes of this section:

(1) *Option* means a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement, the conversion feature of convertible debt (as defined in paragraph (g)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (g)(3) of this section). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a futures contract, a forward contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(2) *Convertible debt* is any indebtedness of a partnership that is convertible into an interest in the partnership that issued the debt.

(3) *Convertible equity* is equity in a partnership that is convertible into a different equity interest in the partnership that issued the convertible equity.

(4) *Exercise* means the exercise of an option in exchange for an interest in the issuing partnership or the conversion of convertible debt or convertible equity into an interest in the issuing partnership.

(5) *Exercise price* means, in the case of a call option, the exercise price of the call option; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of § 1.1275-1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest on the debt and by the fair market value of cash or other

property contributed to the partnership in connection with the conversion.

(h) *Example.* The following example illustrates the provisions of this section:

Example. In Year 1, L and M form general partnership LM with cash contributions of \$5,000 each, which are used to purchase land, Property D, for \$10,000. In that same year, LM issues an option to N to buy a one-third interest in LM at any time before the end of Year 3. The exercise price of the option is \$5,000, payable in either cash or property. N transfers Property E with a basis of \$600 and a value of \$1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (f) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with § 1.1001-1, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes \$400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any income for the premium (the property received in exchange for the option). The partnership has a basis of \$1,000 in Property E. In Year 3, when the partnership property is valued at \$16,000, N exercises the option, contributing Property F with a basis of \$3,000 and a fair market value of \$5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of \$3,000 in Property F. The partnership does not recognize income for the premium (Property E) upon exercise of the option. See § 1.704-1(b)(2)(iv)(d)(4) and (s) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(i) *Effective/applicability date.* This section applies to noncompensatory options that are issued on or after February 5, 2013.

[T.D. 9612, 78 FR 8012, Feb. 5, 2013]

§ 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 § 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 § 1.752-1. See § 1.460-4(k)(3)(iv)(A) for rules relating to basis adjustments required where a contract accounted for under a long-term contract method of accounting is transferred in a contribution to which section 721(a) applies. 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 percent 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 percent of \$6,000)	4,800
.....	(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).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9137, 69 FR 42558, July 16, 2004]

§ 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). See § 1.460-4(k)(3)(iv)(B)(2) for rules relating to adjustments to the basis of contracts accounted for using a long-term contract method of accounting that are acquired in certain contributions to which section 721(a) applies.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9137, 69 FR 42558, July 16, 2004]

DISTRIBUTIONS BY A PARTNERSHIP

§ 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