

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.

[T.D. 7891, 48 FR 20049, May 4, 1983]

#### CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

##### CONTRIBUTIONS TO A PARTNERSHIP

#### **§ 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 § 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

## § 1.721-1

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 § 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

## 26 CFR Ch. I (4-1-16 Edition)

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.

(d) *Debt-for-equity exchange*—(1) *In general*. Except as otherwise provided in section 721 and the regulations under section 721, section 721 applies to a contribution of a partnership's indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership (debt-for-equity exchange). See § 1.108-8(a) for rules in determining the debtor partnership's discharge of indebtedness income.

(2) *Exception*. Section 721 does not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. The debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest (including accrued original issue discount).

(3) *Cross reference*. For rules in determining whether a partnership interest transferred to a creditor in a debt-for-equity exchange is treated as payment of interest or accrued original issue discount, see §§ 1.446-2 and 1.1275-2, respectively.

(4) *Effective/applicability date*. This paragraph (d) applies to debt-for-equity

**Internal Revenue Service, Treasury****§ 1.721-2**

exchanges occurring on or after November 17, 2011.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8665, 61 FR 19189, May 1, 1996; T.D. 9557, 76 FR 71259, Nov. 17, 2011]

**§ 1.721-2 Noncompensatory options.**

(a) *Exercise of a noncompensatory option*—(1) *In general.* Notwithstanding § 1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (g)(4) of this section) of a noncompensatory option (as defined in paragraph (f) of this section). Except as provided in paragraph (a)(2) of this section, section 721 applies to the exercise of a noncompensatory option when the holder pays the exercise price with either property or cash, regardless of whether the terms of the option require or permit cash payment. However, if the exercise price (as defined in paragraph (g)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, then general tax principles will apply to determine the tax consequences of the transaction.

(2) *Exception.* Section 721 does not apply to the exercise of a noncompensatory option to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation. The issuing partnership will not recognize gain or loss upon the transfer of a partnership interest to an exercising option holder in satisfaction of such unpaid rent, royalties, or interest (including accrued original issue discount).

(b) *Transfer of property or satisfaction of an obligation in exchange for a noncompensatory option*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option, or to the satisfaction of a partnership obligation with a noncompensatory option.

(2) *Exception.* Section 721 does apply to a transfer of property to a partnership in exchange for convertible equity

(as defined in paragraph (g)(3) of this section).

(c) *Lapse of a noncompensatory option.* Section 721 does not apply to the lapse of a noncompensatory option.

(d) *Cash settlement of a noncompensatory option.* Section 721 does not apply to the settlement of a noncompensatory option in cash or property other than a partnership interest in the issuing partnership.

(e) *Issuance of a partnership interest in satisfaction of indebtedness for interest on convertible debt.* Section 721 does not apply to the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on the convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. The debtor partnership will not, however, recognize gain or loss upon such conversion. For rules in determining whether a partnership interest transferred to a creditor is treated as payment of interest or accrued original issue discount, see §§ 1.446-2 and 1.1275-2, respectively.

(f) *Scope.* The provisions of this section apply only to noncompensatory options. For purposes of this section, 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

**§ 1.722-1****26 CFR Ch. I (4-1-16 Edition)**

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 part-

nership 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

**Internal Revenue Service, Treasury****§ 1.731-1**

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 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)).