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(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 (other than decreases to the property's book value pursuant to § 1.704-1(b)(2)(iv)(f) or § 1.704-1(b)(2)(iv)(s)). 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 (other than increases to the property's book value pursuant to § 1.704-1(b)(2)(iv)(f) or § 1.704-1(b)(2)(iv)(s)). For purposes of paragraph (a)(6)(iii) and (iv) of this section, a built-in gain or built-in loss referred to in this paragraph shall be referred to as a forward section 704(c) allocation. See § 1.460-4(k)(3)(v)(A) for a rule relating to the amount of built-in income or built-in loss attributable to a contract accounted for under a long-term contract method of accounting.

(iii) *Effective/applicability date.*—The provisions of paragraph (a)(3)(ii) of this section apply to partnership contributions and transactions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

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(6)(i) *Revaluations under section 704(b).*—The principles of this section apply with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f) or § 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations). Each such revaluation creates a separate amount of built-in gain or built-in loss, as the case may be (a section 704(c) layer), that must be tracked separately from built-in gain or built-in loss arising from contribution (a forward section 704(c) layer) and any other revaluation (a reverse section 704(c) layer). For instance, one section 704(c) layer with respect to a particular property may be of built-in gain, and another section 704(c) layer with respect to the same property may be of built-in loss.

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(iii) *Allocation method.*—A partnership may use any reasonable method to allocate the items of income, gain, loss, and deduction associated with an item of property among the property's forward and reverse section 704(c) layers.

(iv) *Effective/applicability date.*—The provisions of paragraph (a)(6)(iii) of this section apply to partnership contributions and transactions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

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(7) *Transfers of a partnership interest.*—If a contributing partner transfers a partnership interest, built-in gain 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 proportionate to the interest transferred must be allocated to the transferee partner. Rules for the allocation of built-in loss are provided in paragraph (f) of this section.

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(f) *Special rules for built-in loss property.*—(1) *General principles.*—(i) *Contributing partner.*—If a partner contributes section 704(c)(1)(C) property (as defined in paragraph (f)(2)(i) of this section) to a partnership, the excess of the adjusted basis of the section 704(c)(1)(C) property (determined without regard to paragraph (f)(1)(ii) of this section) over its fair market value immediately before the contribution will be taken into account only in determining the amount of items allocated to the section 704(c)(1)(C) partner (as defined in paragraph (f)(2)(ii) of this section) that contributed such section 704(c)(1)(C) property.

(ii) *Non-contributing partners.*—In determining the amount of items allocated to partners other than the section 704(c)(1)(C) partner, the initial basis of section 704(c)(1)(C) property in the hands of the partnership is equal to the property's fair market value at the time of contribution.

(2) *Definitions.*—For purposes of this section—

(i) *Section 704(c)(1)(C) property.*—The term *section 704(c)(1)(C) property* means section 704(c) property (as defined in paragraph (a)(3)(i) of this section) with a built-in loss at the

time of contribution. Section 704(c)(1)(C) property does not include a § 1.752-7 liability (within the meaning of § 1.752-7(b)(3)) or property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to § 1.704-1(b)(2)(iv)(f) or § 1.704-1(b)(2)(iv)(s).

(ii) *Section 704(c)(1)(C) partner.*—The term *section 704(c)(1)(C) partner* means a partner that contributes section 704(c)(1)(C) property to a partnership.

(iii) *Section 704(c)(1)(C) basis adjustment.*—A property's section 704(c)(1)(C) basis adjustment is initially equal to the excess of the adjusted basis of section 704(c)(1)(C) property (determined without regard to paragraph (f)(1)(ii) of this section) over its fair market value immediately before the contribution, and is subsequently adjusted for the recovery of the section 704(c)(1)(C) basis adjustment under paragraph (f)(3)(ii)(D) of this section.

(3) *Operational rules.*—(i) *In general.*—Except as provided in this section, section 704(c)(1)(C) property is subject to the rules and regulations applicable to section 704(c) property. See, for example, § 1.704-3(a)(9).

(ii) *Effect of section 704(c)(1)(C) basis adjustment.*—(A) *In general.*—The section 704(c)(1)(C) basis adjustment is an adjustment to the basis of partnership property with respect to the section 704(c)(1)(C) partner only. A section 704(c)(1)(C) basis adjustment amount is excluded from the partnership's basis of section 704(c)(1)(C) property. Thus, for purposes of calculating income, deduction, gain, and loss, the section 704(c)(1)(C) partner will have a special basis for section 704(c)(1)(C) property in which the partner has a section 704(c)(1)(C) basis adjustment. The section 704(c)(1)(C) basis adjustment has no effect on the partnership's computation of any item under section 703.

(B) *Computation of section 704(c)(1)(C) partner's distributive share of partnership items.*—The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the section 704(c)(1)(C) partner, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the section 704(c)(1)(C) partner's distributive share of the items of partnership income, deduction, gain, or loss in accordance with paragraphs (f)(3)(ii)(C) and (D) of this section, to reflect the effects of the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment. These adjustments to the section 704(c)(1)(C) partner's distributive share must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). The adjustments to the section 704(c)(1)(C) partner's distributive shares do not affect the section 704(c)(1)(C) partner's capital account.

(C) *Effect of section 704(c)(1)(C) basis adjustment in determining items of income, gain, or loss.*—The amount of a section 704(c)(1)(C) partner's income, gain, or loss from the sale or exchange of partnership property in which the section 704(c)(1)(C) partner has a section 704(c)(1)(C) basis adjustment is equal to the section 704(c)(1)(C) partner's share of the partnership's gain or loss from the sale of the property (including any remedial allocations under § 1.704-3(d)), minus the section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment for the partnership property.

(D) *Effect of section 704(c)(1)(C) basis adjustment in determining items of deduction.*—(1) *In general.*—If section 704(c)(1)(C) property is subject to amortization under section 197, depreciation under section 168, or other cost recovery in the hands of the section 704(c)(1)(C) partner, the section 704(c)(1)(C) basis adjustment associated with the property is recovered in accordance with section 197(f)(2), section 168(i)(7), or another applicable Internal Revenue Code section. The amount of any section 704(c)(1)(C) basis adjustment that is recovered by the section 704(c)(1)(C) partner in any year is added to the section 704(c)(1)(C) partner's distributive share of the partnership's depreciation or amortization deductions for the year. The basis adjustment is adjusted under section 1016(a)(2) to reflect the recovery of the section 704(c)(1)(C) basis adjustment.

(2) *Example.*—A contributes Property, with an adjusted basis of \$12,000 and a fair market value of \$5,000 on January 1 of the year of contribution, and B contributes \$5,000 to PRS, a partnership. Prior to the contribution, A depreciates Property under section 168 over 10 years using the straight-line method and the half-year convention. On the contribution date, Property has 7.5 years remaining in its recovery period. Property is section 704(c)(1)(C) property, and A's section 704(c)(1)(C) basis adjustment is \$7,000. PRS's basis in Property is \$5,000 (fair market value) and, in accordance with section 168(i)(7), the depreciation is \$667 per year (\$5,000 divided by 7.5 years), which is shared equally between A and B. A's \$7,000 section 704(c)(1)(C)