Internal Revenue Code and Regulations
Partnership Tax Selected Sections
2023

version of November 12, 2022

Introduction

This packet contains (1) an edited table of contents of the Internal Revenue Code, (2) Revenue Procedure 2022-38, which adjusts various provisions of the Code for inflation for 2023, (3) selected sections of the Internal Revenue Code, and (4) selected sections of the regulations associated with the Internal Revenue Code. The packet is designed for Partnership Taxation taught by Sarah Lawsky in 2023.

The edited table of contents is not the table of contents of this volume. Rather, it is an edited table of contents of the entire Internal Revenue Code (USC title 26), to provide a sense of the structure of the Code, with a particular focus on the sections related to partnership taxation.

This revenue procedure, Rev. Proc. 2022-38, provides inflation adjustments for 2023.

The selected sections of the Internal Revenue Code, 26 USC, are drawn from a government website that permits downloading of the United States Code:

https://uscode.house.gov/download/download.shtml

The release point for this version of the Code included here is October 19, 2022. (I do not believe there are any relevant revisions to the Code after that date.)

The selected sections of the regulations, 26 CFR, are drawn from a government website that permits downloading of the Code of Federal Regulations:

https://www.ecfr.gov/

The release point for the regulations included here is November 09, 2022. (I do not believe there are any relevant revisions to the regulations after that date.) The material was drawn from this link:

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Edited

2023

UNITED STATES CODE

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Revenue Procedure 2022-38

Part III

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SECTION 1. PURPOSE

This revenue procedure sets forth inflation-adjusted items for 2023 for various Code provisions as in effect on October 18, 2022. The inflation adjusted items for the Code sections set forth in section 3 of this revenue procedure are generally determined by reference to § 1(f) of the Code. To the extent amendments to the Code are enacted for 2023 after October 18, 2022, taxpayers should consult additional guidance to determine whether these adjustments remain applicable for 2023.

SECTION 2. CHANGES

.01 For taxable years beginning after December 31, 2022, § 13303(a)(1) of Public Law 117-169, 136 Stat. 1818 (August 16, 2022), commonly known as the Inflation Reduction Act of 2022 (IRA), modifies the maximum amount of the energy efficient commercial buildings deduction under § 179D.

(1) For taxable years beginning in 2023, the applicable dollar value used to determine the maximum allowance of the deduction under § 179D(b) is $0.50 increased (but not above $1.00) by $0.02 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

(2) For taxable years beginning in 2023, the applicable dollar value used to determine the increased deduction amount for certain property under § 179D(b)(3)(A) is $2.50 increased (but not above $5.00) by $0.10 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

.02 The amounts set forth in section 2.01 of this revenue procedure are adjusted for inflation for taxable years beginning in 2023.

SECTION 3. 2023 ADJUSTED ITEMS

.01 Tax Rate Tables. For taxable years beginning in 2023, the tax rate tables under § 1 are as follows:

TABLE 1 - Section 1(j)(2)(A) - Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is:	The Tax Is:
Not over $22,000	10% of the taxable income
Over $22,000 but not over $89,450	$2,200 plus 12% of the excess over $22,000
Over $89,450 but not over $190,750	$10,294 plus 22% of the excess over $89,450
Over $190,750 but not over $364,200	$32,580 plus 24% of the excess over $190,750
Over $364,200 but not over $462,500	$74,208 plus 32% of the excess over $364,200
Over $462,500 but not over $693,750	$105,664 plus 35% of the excess over $462,500
Over $693,750	$186,601.50 plus 37% of the excess over $693,750

TABLE 2 - Section 1(j)(2)(B) – Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $15,700	10% of the taxable income
Over $15,700 but not over $59,850	$1,570 plus 12% of the excess over $15,700
Over $59,850 but not over $95,350	$6,868 plus 22% of the excess over $59,850
Over $95,350 but not over $182,100	$14,678 plus 24% of the excess over $95,350
Over $182,100 but not over $231,250	$35,498 plus 32% of the excess over $182,100
Over $231,250 but not over $578,100	$51,226 plus 35% of the excess over $231,250
Over $578,100	$172,623.50 plus 37% of the excess over $578,100

TABLE 3 - Section 1(j)(2)(C) – Unmarried Individuals (other than Surviving Spouses and Heads of Households)

If Taxable Income Is:	The Tax Is:
Not over $11,000	10% of the taxable income
Over $11,000 but not over $44,725	$1,100 plus 12% of the excess over $11,000
Over $44,725 but not over $95,375	$5,147 plus 22% of the excess over $44,725
Over $95,375 but not over $182,100	$16,290 plus 24% of the excess over $95,375
Over $182,100 but not over $231,250	$37,104 plus 32% of the excess over $182,100
Over $231,250 but not over $578,125	$52,832 plus 35% of the excess over $231,250
Over $578,125	$174,238.25 plus 37% of the excess over $578,125

TABLE 4 - Section 1(j)(2)(D) – Married Individuals Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $11,000	10% of the taxable income
Over $11,000 but not over $44,725	$1,100 plus 12% of the excess over $11,000
Over $44,725 but not over $95,375	$5,147 plus 22% of the excess over $44,725
Over $95,375 but not over $182,100	$16,290 plus 24% of the excess over $95,375
Over $182,100 but not over $231,250	$37,104 plus 32% of the excess over $182,100
Over $231,250 but not over $346,875	$52,832 plus 35% of the excess over $231,250
Over $346,875	$93,300.75 plus 37% of the excess over $346,875

TABLE 5 - Section 1(j)(2)(E) – Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $2,900	10% of the taxable income
Over $2,900 but not over $10,550	$290 plus 24% of the excess over $2,900
Over $10,550 but not over $14,450	$2,126 plus 35% of the excess over $10,550
Over $14,450	$3,491 plus 37% of the excess over $14,450

.02 Unearned Income of Minor Children Subject to the "Kiddie Tax". For taxable years beginning in 2023, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $1,250. This $1,250 amount is the same as the amount provided in § 63(c)(5)(A), as adjusted for inflation. The same $1,250 amount is used for purposes of § 1(g)(7) to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the "kiddie tax." For example, one of the requirements for the parental election is that a child's gross income is more than the amount referenced in § 1(g)(4)(A)(ii)(I) but less than 10 times that amount; thus, a child's gross income for 2023 must be more than $1,250 but less than $12,500.

.03 Maximum Capital Gains Rate (§1(h), §1(j)(5)). For taxable years beginning in 2023, the maximum zero rate amounts and maximum 15 percent rate amounts under § 1(j)(5)(B) are as follows:

Filing Status	Maximum Zero Rate Amount	Maximum15% Rate Amount
Married Individuals Filing Joint Returns and Surviving Spouse	$89,250	$553,850
Married Individuals Filing Separate Returns	$44,625	$276,900

Heads of Household	$59,750	$523,050
All Other Individuals	$44,625	$492,300
Estates and Trusts	$3,000	$14,650

.04 Adoption Credit. For taxable years beginning in 2023, under § 23(a)(3) the credit allowed for an adoption of a child with special needs is $15,950. For taxable years beginning in 2023, under § 23(b)(1) the maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to $15,950. The available adoption credit begins to phase out under § 23(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $239,230 and is completely phased out for taxpayers with modified adjusted gross income of $279,230 or more. See section 3.19 of this revenue procedure for the adjusted items relating to adoption assistance programs.

.05 Child Tax Credit. For taxable years beginning in 2023, the amount used in § 24(d)(1)(A) to determine the amount of credit under § 24 that may be refundable is $1,600.

.06 Earned Income Credit.

(1) In general. For taxable years beginning in 2023, the following amounts are used to determine the earned income credit under § 32(b). The “earned income amount” is the amount of earned income at or above which the maximum amount of the earned income credit is allowed. The “threshold phaseout amount” is the amount of adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The “completed phaseout amount” is the amount of adjusted gross income (or, if greater, earned income) at or above which no credit is allowed. The threshold phaseout amounts and the completed phaseout amounts shown in the table below for married taxpayers filing a joint return include the

increase provided in § 32(b)(2)(B), as adjusted for inflation for taxable years beginning in 2023. The threshold phaseout amounts and the completed phaseout amounts shown in the table below for single, surviving spouse, or head of household taxpayers also apply to married taxpayers who are not filing a joint return and satisfy the special rules for separated spouses in § 32(d).

	Number of Qualifying Children			
Item	One	Two	Three or More	None
Earned Income Amount	$11,750	$16,510	$16,510	$7,840
Maximum Amount of Credit	$3,995	$6,604	$7,430	$600
Threshold Phaseout Amount (Single, Surviving Spouse, or Head of Household)	$21,560	$21,560	$21,560	$9,800
Completed Phaseout Amount (Single, Surviving Spouse, or Head of Household)	$46,560	$52,918	$56,838	$17,640
Threshold Phaseout Amount (Married Filing Jointly)	$28,120	$28,120	$28,120	$16,370
Completed Phaseout Amount (Married Filing Jointly)	$53,120	$59,478	$63,398	$24,210

The instructions for the Form 1040 series provide tables showing the amount of the earned income credit for each type of taxpayer.

(2) Excessive Investment Income. For taxable years beginning in 2023, the earned income tax credit is not allowed under § 32(i) if the aggregate amount of certain investment income exceeds $11,000.

.07 Refundable Credit for Coverage Under a Qualified Health Plan. For taxable years beginning in 2023, the limitation on tax imposed under § 36B(f)(2)(B) for excess advance credit payments is determined using the following table:

If the household income (expressed as a percent of poverty line) is:	The limitation amount for unmarried individuals (other than surviving spouses and heads of household) is:	The limitation amount for all other taxpayers is:
Less than 200%	$350	$700
At least 200% but less than 300%	$900	$1,800
At least 300% but less than 400%	$1,500	$3,000

.08 Rehabilitation Expenditures Treated as Separate New Building. For calendar year 2023, the per low-income unit qualified basis amount under § 42(e)(3)(A)(ii)(II) is $7,900.

.09 Low-Income Housing Credit. For calendar year 2023, the amount used under § 42(h)(3)(C)(ii) to calculate the State housing credit ceiling for the low-income housing credit is the greater of (1) $2.75 multiplied by the State population, or (2) $3,185,000.

.10 Employee Health Insurance Expense of Small Employers. For taxable years beginning in 2023, the dollar amount in effect under § 45R(d)(3)(B) is $30,700. This amount is used under § 45R(c) for limiting the small employer health insurance credit and under § 45R(d)(1)(B) for determining who is an eligible small employer for purposes of the credit.

.11 Exemption Amounts for Alternative Minimum Tax. For taxable years beginning in 2023, the exemption amounts under § 55(d)(1) are:

Joint Returns or Surviving Spouses	$126,500
Unmarried Individuals (other than Surviving Spouses)	$81,300

Married Individuals Filing Separate Returns	$63,250
Estates and Trusts	$28,400

For taxable years beginning in 2023, under § 55(b)(1), the excess taxable income above which the 28 percent tax rate applies is:

Married Individuals Filing Separate Returns	$110,350
All Other Taxpayers	$220,700

For taxable years beginning in 2023, the amounts used under § 55(d)(2) to determine the phaseout of the exemption amounts are:

	Threshold Phaseout amount	Complete Phaseout amount
Joint Returns or Surviving Spouses	$1,156,300	$1,662,300
Unmarried Individuals (other than Surviving Spouses)	$578,150	$903,350
Married Individuals Filing Separate Returns	$578,150	$831,150
Estates and Trusts	$94,600	$208,200

.12 Alternative Minimum Tax Exemption for a Child Subject to the "Kiddie Tax." For taxable years beginning in 2023, for a child to whom the § 1(g) "kiddie tax" applies, the exemption amount under §§ 55(d) and 59(j) for purposes of the alternative minimum tax under § 55 may not exceed the sum of (1) the child's earned income for the taxable year, plus (2) $8,800.

.13 Certain Expenses of Elementary and Secondary School Teachers. For taxable years beginning in 2023, under § 62(a)(2)(D) the amount of the deduction allowed under § 162 that consists of expenses paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom is $300.

.14 Transportation Mainline Pipeline Construction Industry Optional Expense Substantiation Rules for Payments to Employees Under Accountable Plans. For calendar year 2023, an eligible employer may pay certain welders and heavy equipment mechanics an amount up to $20 per hour for rig-related expenses that are deemed substantiated under an accountable plan if paid in accordance with Rev. Proc. 2002-41, 2002-1 C.B. 1098. If the employer provides fuel or otherwise reimburses fuel expenses, an amount up to $13 per hour is deemed substantiated if paid under Rev. Proc. 2002-41.

.15 Standard Deduction.

(1) In general. For taxable years beginning in 2023, the standard deduction amounts under § 63(c)(2) are as follows:

Filing Status	Standard Deduction
Married Individuals Filing Joint Returns and Surviving Spouses (§ 1(j)(2)(A))	$27,700
Heads of Households (§ 1(j)(2)(B))	$20,800
Unmarried Individuals (other than Surviving Spouses and Heads of Households) (§ 1(j)(2)(C))	$13,850
Married Individuals Filing Separate Returns (§ 1(j)(2)(D))	$13,850

(2) Dependent. For taxable years beginning in 2023, the standard deduction amount under § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,250, or (2) the sum of $400 and the individual’s earned income.

(3) Aged or blind. For taxable years beginning in 2023, the additional standard deduction amount under § 63(f) for the aged or the blind is $1,500. The additional standard deduction amount is increased to $1,850 if the individual is also unmarried and not a surviving spouse.

.16 Cafeteria Plans. For taxable years beginning in 2023, the dollar limitation under § 125(i) on voluntary employee salary reductions for contributions to health flexible spending arrangements is $3,050. If the cafeteria plan permits the carryover of unused amounts, the maximum carryover amount is $610.

.17 Qualified Transportation Fringe Benefit. For taxable years beginning in 2023, the monthly limitation under § 132(f)(2)(A) regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $300. The monthly limitation under § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $300.

.18 Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses. For taxable years beginning in 2023, the exclusion under § 135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above $137,800 for joint returns and $91,850 for all other returns. The exclusion is completely phased out for modified adjusted gross income of $167,800 or more for joint returns and $106,850 or more for all other returns.

.19 Adoption Assistance Programs. For taxable years beginning in 2023, under § 137(a)(2), the amount that can be excluded from an employee's gross income for the adoption of a child with special needs is $15,950. For taxable years beginning in 2023, under § 137(b)(1) the maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for adoptions by the employee is $15,950. The amount excludable from an employee's gross income begins to phase out under § 137(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $239,230 and is completely phased out for taxpayers with modified adjusted gross income of $279,230 or more. (See section 3.04 of this revenue procedure for the adjusted items relating to the adoption credit.)

.20 Private Activity Bonds Volume Cap. For calendar year 2023, the amounts used under § 146(d) to calculate the State ceiling for the volume cap for private activity bonds is the greater of (1) $120 multiplied by the State population, or (2) $358,845,000.

.21 Loan Limits on Agricultural Bonds. For calendar year 2023, the loan limit amount on agricultural bonds under § 147(c)(2)(A) for first-time farmers is $616,100.

.22 General Arbitrage Rebate Rules. For bond years ending in 2023, the amount of the computation credit determined under § 1.148-3(d)(4) of the Income Tax Regulations is $1,960.

.23 Safe Harbor Rules for Broker Commissions on Guaranteed Investment Contracts or Investments Purchased for a Yield Restricted Defeasance Escrow. For calendar year 2023, under § 1.148-5(e)(2)(iii)(B)(1), a broker's commission or similar fee for the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is reasonable if (1) the amount of the fee that the issuer treats as a qualified administrative cost does not exceed the lesser of (A) $46,000, and (B) 0.2 percent of the computational base (as defined in § 1.148-5(e)(2)(iii)(B)(*2*)) or, if more, $5,000; and (2) for any issue, the issuer does not treat more than $130,000 in brokers' commissions or similar fees as qualified administrative costs for all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue.

.24 Gross Income Limitation for a Qualifying Relative. For taxable years beginning in 2023, the exemption amount referenced in § 152(d)(1)(B) is $4,700.

.25 Election to Expense Certain Depreciable Assets. For taxable years beginning in 2023, under § 179(b)(1), the aggregate cost of any § 179 property that a taxpayer elects to treat as an expense cannot exceed $1,160,000 and under § 179(b)(5)(A), the cost of any sport utility vehicle that may be taken into account under § 179 cannot exceed $28,900. Under § 179(b)(2), the $1,160,000 limitation under § 179(b)(1) is reduced (but not below zero) by the amount by which the cost of § 179 property placed in service during the 2023 taxable year exceeds $2,890,000.

.26 Energy Efficient Commercial Building Deduction. For taxable years beginning in 2023, the applicable dollar value used to determine the maximum allowance of the deduction under § 179D(b)(2) is $0.54 increased (but not above $1.07) by $0.02 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent. For taxable years beginning in 2023, the applicable dollar value used to determine the increased deduction amount for certain property under § 179D(b)(3) is $2.68 increased (but not above $5.36) by $0.11 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

.27 Qualified Business Income. For taxable years beginning in 2023, the threshold amounts under § 199A(e)(2) and phase-in range amounts under § 199A(b)(3)(B) and § 199A(d)(3)(A) are:

Filing Status	Threshold amount	Phase-in range amount
Married Individuals Filing Joint Returns	$364,200	$464,200
Married Individuals Filing Separate Returns	$182,100	$232,100
All Other Returns	$182,100	$232,100

.28 Eligible Long-Term Care Premiums. For taxable years beginning in 2023, the limitations under § 213(d)(10), regarding eligible long-term care premiums includible in the term "medical care," are as follows:

Attained Age Before the Close of the Taxable Year	Limitation on Premiums
40 or less	$480
More than 40 but not more than 50	$890
More than 50 but not more than 60	$1,790
More than 60 but not more than 70	$4,770
More than 70	$5,960

.29 Medical Savings Accounts.

(1) Self-only coverage. For taxable years beginning in 2023, the term "high deductible health plan" as defined in § 220(c)(2)(A) means, for self-only coverage, a health plan that has an annual deductible that is not less than $2,650 and not more than $3,950, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $5,300.

(2) Family coverage. For taxable years beginning in 2023, the term "high deductible health plan" means, for family coverage, a health plan that has an annual deductible that is not less than $5,300 and not more than $7,900, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $9,650.

.30 Interest on Education Loans. For taxable years beginning in 2023, the $2,500 maximum deduction for interest paid on qualified education loans under § 221 begins to phase out under § 221(b)(2)(B) for taxpayers with modified adjusted gross income in excess of $75,000 ($155,000 for joint returns), and is completely phased out for taxpayers with modified adjusted gross income of $90,000 or more ($185,000 or more for joint returns).

.31 Limitation on Use of Cash Method of Accounting. For taxable years beginning in 2023, a corporation or partnership meets the gross receipts test of § 448(c) for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $29,000,000.

.32 Threshold for Excess Business Loss. For taxable years beginning in 2023, in determining a taxpayer's excess business loss, the amount under § 461(l)(3)(A)(ii)(II) is $289,000 ($578,000 for joint returns).

.33 Treatment of Dues Paid to Agricultural or Horticultural Organizations. For taxable years beginning in 2023, the limitation under § 512(d)(1), regarding the exemption of annual dues required to be paid by a member to an agricultural or horticultural organization, is $191.

.34 Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.

(1) Low cost article. For taxable years beginning in 2023, for purposes of defining the term "unrelated trade or business" for certain exempt organizations under § 513(h)(2), "low cost articles" are articles costing $12.50 or less.

(2) Other insubstantial benefits. For taxable years beginning in 2023, under § 170, the $5, $25, and $50 guidelines in section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987, and modified by Rev. Proc. 92-102, 1992-2 C.B. 579), for the value of insubstantial benefits that may be received by a donor in return for a contribution, without causing the contribution to fail to be fully deductible, are $12.50, $62.50 and $125, respectively.

.35 Special Rules for Credits and Deductions. For taxable years beginning in 2023, the amount of the deduction under § 642(b)(2)(C)(i) is $4,700.

.36 Tax on Insurance Companies Other than Life Insurance Companies. For taxable years beginning in 2023, under § 831(b)(2)(A)(i) the amount of the limit on net written premiums or direct written premiums (whichever is greater) is $2,650,000 to elect the alternative tax for certain small companies under § 831(b)(1) to be taxed only on taxable investment income.

.37 Expatriation to Avoid Tax. For calendar year 2023, under § 877A(g)(1)(A), unless an exception under § 877A(g)(1)(B) applies, an individual is a covered expatriate if the individual's "average annual net income tax" under § 877(a)(2)(A) for the five taxable years ending before the expatriation date is more than $190,000.

.38 Tax Responsibilities of Expatriation. For taxable years beginning in 2023, the amount that would be includible in the gross income of a covered expatriate by reason of § 877A(a)(1) is reduced (but not below zero) by $821,000 pursuant to § 877A(a)(3).

.39 Foreign Earned Income Exclusion. For taxable years beginning in 2023, the foreign earned income exclusion amount under § 911(b)(2)(D)(i) is $120,000.

.40 Debt Instruments Arising Out of Sales or Exchanges. For calendar year 2023, a qualified debt instrument under § 1274A(b) has stated principal that does not exceed

$6,734,800, and a cash method debt instrument under § 1274A(c)(2) has stated principal that does not exceed $4,810,600.

.41 Unified Credit Against Estate Tax. For an estate of any decedent dying in calendar year 2023, the basic exclusion amount is $12,920,000 for determining the amount of the unified credit against estate tax under § 2010.

.42 Valuation of Qualified Real Property in Decedent's Gross Estate. For an estate of a decedent dying in calendar year 2023, if the executor elects to use the special use valuation method under § 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use § 2032A for purposes of the estate tax cannot exceed $1,310,000.

.43 Annual Exclusion for Gifts.

(1) For calendar year 2023, the first $17,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under § 2503 made during that year.

(2) For calendar year 2023, the first $175,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §§ 2503 and 2523(i)(2) made during that year.

.44 Tax on Arrow Shafts. For calendar year 2023, the tax imposed under § 4161(b)(2)(A) on the first sale by the manufacturer, producer, or importer of any shaft of a type used in the manufacture of certain arrows is $0.59 per shaft.

.45 Passenger Air Transportation Excise Tax. For calendar year 2023, the tax under § 4261(b)(1) on the amount paid for each domestic segment of taxable air transportation is $4.80. For calendar year 2023, the tax under § 4261(c)(1) on any amount paid (whether within or without the United States) for any international air transportation, if the transportation begins or ends in the United States, generally is $21.10. Under § 4261(c)(3), however, a lower rate of tax applies under § 4261(c)(1) to a domestic segment beginning or ending in Alaska or Hawaii, and the tax applies only to departures. For calendar year 2023, the rate of tax is $10.60.

.46 Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures. For taxable years beginning in 2023, the annual per person, family, or entity dues limitation to qualify for the reporting exception under § 6033(e)(3) (and section 5.05 of Rev. Proc. 98-19, 1998-1 C.B. 547), regarding certain exempt organizations with nondeductible lobbying expenditures, is $132 or less.

.47 Notice of Large Gifts Received from Foreign Persons. For taxable years beginning in 2023, § 6039F authorizes the Secretary of the Treasury or her delegate to require recipients of gifts from certain foreign persons to report these gifts if the aggregate value of gifts received in the taxable year exceeds $18,567.

.48 Persons Against Whom a Federal Tax Lien Is Not Valid. For calendar year 2023, a federal tax lien is not valid against (1) certain purchasers under § 6323(b)(4) who purchased personal property in a casual sale for less than $1,810, or (2) a mechanic's lien or under § 6323(b)(7) who repaired or improved certain residential property if the contract price with the owner is not more than $9,030.

.49 Property Exempt from Levy. For calendar year 2023, the value of property exempt from levy under § 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) cannot exceed $10,810. The value of property exempt from levy under § 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) cannot exceed $5,400.

.50 Exempt Amount of Wages, Salary, or Other Income. For taxable years beginning in 2023, the dollar amount used to calculate the amount determined under § 6334(d)(4)(B) is $4,700.

.51 Interest on a Certain Portion of the Estate Tax Payable in Installments. For an estate of a decedent dying in calendar year 2023, the dollar amount used to determine the “2-percent portion” (for purposes of calculating interest under § 6601(j)) of the estate tax extended as provided in § 6166 is $1,750,000.

.52 Failure to File Tax Return. In the case of any return required to be filed in 2024, the amount of the addition to tax under § 6651(a) for failure to file an income tax return within 60 days of the due date of such return (determined with regard to any extensions of time for filing) will not be less than the lesser of $485 or 100 percent of the amount required to be shown as tax on such return.

.53 Failure to File Certain Information Returns, Registration Statements, etc. For returns required to be filed in 2024, the penalty amounts under § 6652(c) are:

(1) for failure to file a return required under § 6033(a)(1) (relating to returns by exempt organization) or § 6012(a)(6) (relating to returns by political organizations):

Scenario	Daily Penalty	Maximum Penalty
Organization (§ 6652(c)(1)(A))	$20	Lesser of $12,000 or 5% of gross receipts of the organization for the year.
Organization with gross receipts exceeding $1,208,500 (§ 6652(c)(1)(A))	$120	$60,000
Managers (§ 6652(c)(1)(B))	$10	$6,000
Public inspection of annual returns and reports (§ 6652(c)(1)(C))	$20	$12,000
Public inspection of applications for exemption and notice of status (§ 6652(c)(1)(D))	$20	No Limit

(2) for failure to file a return required under § 6034 (relating to returns by certain trust) or § 6043(b) (relating to terminations, etc., of exempt organizations):

Scenario	Daily Penalty	Maximum Penalty
Organization or trust (§ 6652(c)(2)(A))	$10	$6,000
Managers (§ 6652(c)(2)(B))	$10	$6,000
Split-Interest Trust (§ 6652(c)(2)(C)(ii))	$20	$12,000
Any trust with gross income exceeding $302,000 (§ 6652(c)(2)(C)(ii))	$120	$60,000

(3) for failure to file a disclosure required under § 6033(a)(2):

Scenario	Daily Penalty	Maximum Penalty
Tax–exempt entity (§ 6652(c)(3)(A))	$120	$60,000
Failure to comply with written demand (§ 6652(c)(3)(B)(ii))	$120	$12,000

.54 Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons. In the case of any failure relating to a return or claim for refund filed in 2024, the penalty amounts under § 6695 are:

Scenario	Per Return or Claim for Refund	Maximum Penalty
Failure to furnish copy to taxpayer (§ 6695(a))	$60	$30,000
Failure to sign return (§ 6695(b))	$60	$30,000
Failure to furnish identifying number (§ 6695(c))	$60	$30,000
Failure to retain copy or list (§ 6695(d))	$60	$30,000
Failure to file correct information returns (§ 6695(e))	$60 per return and item in return	$30,000
Negotiation of check (§ 6695(f))	$600 per check	No limit
Failure to be diligent in determining eligibility for head of household filing status, child tax credit, American Opportunity tax credit, and earned income credit (§ 6695(g))	$600 per failure	No limit

.55 Failure to File Partnership Return. In the case of any return required to be filed in 2024, the dollar amount used to determine the amount of the penalty under § 6698(b)(1) is $235.

.56 Failure to File S Corporation Return. In the case of any return required to be filed in 2024, the dollar amount used to determine the amount of the penalty under § 6699(b)(1) is $235.

.57 Failure to File Correct Information Returns. In the case of any failure relating to a return required to be filed in 2024, the penalty amounts under § 6721 are:

(1) for persons with average annual gross receipts for the most recent three taxable years of more than $5,000,000, for failure to file correct information returns:

Scenario	Penalty Per Return	Calendar Year Maximum
General Rule (§ 6721(a)(1))	$310	$3,783,000
Corrected on or before 30 days after required filing date (§ 6721(b)(1))	$60	$630,500
Corrected after 30th day but on or before August 1, 2024 (§ 6721(b)(2))	$120	$1,891,500

(2) for persons with average annual gross receipts for the most recent three taxable years of $5,000,000 or less, for failure to file correct information returns:

Scenario	Penalty Per Return	Calendar Year Maximum
General Rule (§ 6721(d)(1)(A))	$310	$1,261,000
Corrected on or before 30 days after required filing date (§ 6721(d)(1)(B))	$60	$220,500
Corrected after 30th day but on or before August 1, 2023 (§ 6721(d)(1)(C))	$120	$630,500

(3) for failure to file correct information returns due to intentional disregard of the filing requirement (or the correct information reporting requirement):

Scenario	Penalty Per Return	Calendar Year Maximum
Return other than a return required to be filed under §§ 6045(a), 6041A(b), 6050H, 6050I, 6050J, 6050K, or 6050L (§ 6721(e)(2)(A))	Greater of (i) $630, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Return required to be filed under §§ 6045(a), 6050K, or 6050L (§ 6721(e)(2)(B))	Greater of (i) $630, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit

Return required to be filed under § 6050I(a) (§ 6721(e)(2)(C))	Greater of (i) $31,520, or (ii) amount of cash received up to $126,000	No limit
Return required to be filed under § 6050V (§ 6721(e)(2)(D))	Greater of (i) $630, or (ii) 10% of the value of the benefit of any contract with respect to which information is required to be included on the return	No limit

.58 Failure to Furnish Correct Payee Statements. In the case of any failure relating to a statement required to be furnished in 2024, the penalty amounts under § 6722 are:

(1) for persons with average annual gross receipts for the most recent three taxable years of more than $5,000,000, for failure to furnish correct payee statements:

Scenario	Penalty Per Statement	Calendar Year Maximum
General Rule (§ 6722(a)(1))	$310	$3,783,000
Corrected on or before 30 days after required furnishing date (§ 6722(b)(1))	$60	$630,500
Corrected after 30th day but on or before August 1, 2024 (§ 6722(b)(2))	$120	$1,891,500

(2) for persons with average annual gross receipts for the most recent 3 taxable years of $5,000,000 or less, for failure to furnish correct payee statements:

Scenario	Penalty Per Statement	Calendar Year Maximum
General Rule (§ 6722(d)(1)(A))	$310	$1,261,000
Corrected on or before 30 days after required furnishing date (§ 6722(d)(1)(B))	$60	$220,500
Corrected after 30th day but on or before August 1, 2024 (§ 6722(d)(1)(C))	$120	$630,500

(3) for failure to furnish correct payee statements due to intentional disregard of the requirement to furnish a payee statement (or the correct information reporting requirement):

Scenario	Penalty Per Statement	Calendar Year Maximum
Payee statement other than a statement required under §§ 6045(b), 6041A(e) (in respect of a return required under § 6041A(b)), 6050H(d), 6050J(e), 6050K(b), or 6050L(c) (§ 6722(e)(2)(A))	Greater of (i) $630, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Payee statement required under §§ 6045(b), 6050K(b), or 6050L(c) (§ 6722(e)(2)(B))	Greater of (i) $630, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit

.59 Revocation or Denial of Passport in Case of Certain Tax Delinquencies. For calendar year 2023, the amount of a serious delinquent tax debt under § 7345 is $59,000.

.60 Attorney Fee Awards. For fees incurred in calendar year 2023, the attorney fee award limitation under § 7430(c)(1)(B)(iii) is $230 per hour.

.61 Periodic Payments Received Under Qualified Long-Term Care Insurance Contracts or Under Certain Life Insurance Contracts. For calendar year 2023, the stated dollar amount of the per diem limitation under § 7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is $420.

.62 Qualified Small Employer Health Reimbursement Arrangement. For taxable years beginning in 2023, to qualify as a qualified small employer health reimbursement arrangement under § 9831(d), the arrangement must provide that the total amount of payments and reimbursements for any year cannot exceed $5,850 ($11,800 for family coverage).

SECTION 4. EFFECTIVE DATE

.01 General Rule. Except as provided in section 4.02 of this revenue procedure, this revenue procedure applies to taxable years beginning in 2023.

.02 Calendar Year Rule. This revenue procedure applies to transactions or events occurring in calendar year 2023 for purposes of sections 3.08 (rehabilitation expenditures treated as separate new building), 3.09 (low-income housing credit), 3.14 (transportation mainline pipeline construction industry optional expense substantiation rules for payments to employees under accountable plans), 3.20 (private activity bonds volume cap), 3.21 (loan limits on agricultural bonds), 3.22 (general arbitrage rebate rules), 3.23 (safe harbor rules for broker commissions on guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow), 3.37 (expatriation to avoid taxes), 3.40 (debt instruments arising out of sales or exchanges), 3.41 (unified credit against estate tax), 3.42 (valuation of qualified real property in decedent's gross estate), 3.43 (annual exclusion for gifts), 3.44 (tax on arrow shafts), 3.45 (passenger air transportation excise tax), 3.48 (persons against whom a federal tax lien is not valid), 3.49 (property exempt from levy), 3.51 (interest on a certain portion of the estate tax payable in installments), 3.59 (revocation or denial of passport in case of certain tax delinquencies), 3.60 (attorney fee awards), and 3.61 (periodic payments received under qualified long-term care insurance contracts or under certain life insurance contracts) of this revenue procedure.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is William Ruane of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Ruane at (202) 317-4718 (not a toll-free call) or Kyle Walker at (202) 317-5394 (not a toll-free call).

Internal Revenue Code
Title 26
Selected Sections

§ 11. Tax imposed

(a) Corporations in general

A tax is hereby imposed for each taxable year on the taxable income of every corporation.

(b) Amount of tax

The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income.

§ 83. Property transferred in connection with performance of services

(a) General rule

If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

(b) Election to include in gross income in year of transfer

(1) In general

Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of—

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(2) Election

An election under paragraph (1) with respect to any transfer of property shall be made in such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the Secretary.

(c) Special rules

For purposes of this section—

(1) Substantial risk of forfeiture

The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) Transferability of property

The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

(3) Sales which may give rise to suit under section 16(b) of the Securities Exchange Act of 1934

So long as the sale of property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, such person's rights in such property are—

(A) subject to a substantial risk of forfeiture, and

(B) not transferable.

(4) For purposes of determining an individual's basis in property transferred in connection with the performance of services, rules similar to the rules of section 72(w) shall apply.

(h) Deduction by employer

In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

§ 168. Accelerated cost recovery system

(i) Definitions and special rules

For purposes of this section—

(1) Class life

Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets. The reference in this paragraph to subsection (m) of section 167 shall be treated as a reference to such subsection as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990.

(2) Qualified technological equipment

(A) In general

The term "qualified technological equipment" means—

(i) any computer or peripheral equipment,

(ii) any high technology telephone station equipment installed on the customer's premises, and

(iii) any high technology medical equipment.

(B) Computer or peripheral equipment defined

For purposes of this paragraph—

(i) In general

The term "computer or peripheral equipment" means—

(I) any computer, and

(II) any related peripheral equipment.

(ii) Computer

The term "computer" means a programmable electronically activated device which—

(I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and

(II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

(iii) Related peripheral equipment

The term "related peripheral equipment" means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

(iv) Exceptions

The term "computer or peripheral equipment" shall not include—

(I) any equipment which is an integral part of other property which is not a computer,

(II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and

(III) equipment of a kind used primarily for amusement or entertainment of the user.

(C) High technology medical equipment

For purposes of this paragraph, the term "high technology medical equipment" means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

(3) Lease term

(A) In general

In determining a lease term—

(i) there shall be taken into account options to renew,

(ii) the term of a lease shall include the term of any service contract or similar arrangement (whether or not treated as a lease under section 7701(e))—

(I) which is part of the same transaction (or series of related transactions) which includes the lease, and

(II) which is with respect to the property subject to the lease or substantially similar property, and

(iii) 2 or more successive leases which are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar property shall be treated as 1 lease.

(B) Special rule for fair rental options on nonresidential real property or residential rental property

For purposes of clause (i) of subparagraph (A), in the case of nonresidential real property or residential rental property, there shall not be taken into account any option to renew at fair market value, determined at the time of renewal.

(4) General asset accounts

Under regulations, a taxpayer may maintain 1 or more general asset accounts for any property to which this section applies. Except as provided in regulations, all proceeds realized on any disposition of property in a general asset account shall be included in income as ordinary income.

(5) Changes in use

The Secretary shall, by regulations, provide for the method of determining the deduction allowable under section 167(a) with respect to any tangible property for any taxable year (and the succeeding taxable years) during which such property changes status under this section but continues to be held by the same person.

(6) Treatments of additions or improvements to property

In the case of any addition to (or improvement of) any property—

(A) any deduction under subsection (a) for such addition or improvement shall be computed in the same manner as the deduction for such property would be computed if such property had been placed in service at the same time as such addition or improvement, and

(B) the applicable recovery period for such addition or improvement shall begin on the later of—

(i) the date on which such addition (or improvement) is placed in service, or

(ii) the date on which the property with respect to which such addition (or improvement) was made is placed in service.

(7) Treatment of certain transferees

(A) In general

In the case of any property transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of computing the depreciation deduction determined under this section with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. In any case where this section as in effect before the amendments made by section 201 of the Tax Reform Act of 1986 applied to the property in the hands of the transferor, the reference in the preceding sentence to this section shall be treated as a reference to this section as so in effect.

(B) Transactions covered

The transactions described in this subparagraph are—

(i) any transaction described in section 332, 351, 361, 721, or 731, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(C) Property reacquired by the taxpayer

Under regulations, property which is disposed of and then reacquired by the taxpayer shall be treated for purposes of computing the deduction allowable under subsection (a) as if such property had not been disposed of.

(8) Treatment of leasehold improvements

(A) In general

In the case of any building erected (or improvements made) on leased property, if such building or improvement is property to which this section applies, the depreciation deduction shall be determined under the provisions of this section.

(B) Treatment of lessor improvements which are abandoned at termination of lease

An improvement—

(i) which is made by the lessor of leased property for the lessee of such property, and

(ii) which is irrevocably disposed of or abandoned by the lessor at the termination of the lease by such lessee,

shall be treated for purposes of determining gain or loss under this title as disposed of by the lessor when so disposed of or abandoned.

(C) Cross reference

For treatment of qualified long-term real property constructed or improved in connection with cash or rent reduction from lessor to lessee, see section 110(b).

(9) Normalization rules

(A) In general

In order to use a normalization method of accounting with respect to any public utility property for purposes of subsection (f)(2)—

(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property (respecting all elections made by the taxpayer under this section) differs from the amount that would be allowable as a deduction under section 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

(B) Use of inconsistent estimates and projections, etc.

(i) In general

One way in which the requirements of subparagraph (A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

(ii) Use of inconsistent estimates and projections

The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

(iii) Regulatory authority

The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).

(C) Public utility property which does not meet normalization rules

In the case of any public utility property to which this section does not apply by reason of subsection (f)(2), the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (A)(i).

(10) Public utility property

The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(A) electrical energy, water, or sewage disposal services,

(B) gas or steam through a local distribution system,

(C) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(D) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(11) Research and experimentation

The term "research and experimentation" has the same meaning as the term research and experimental has under section 174.

(12) Section 1245 and 1250 property

The terms "section 1245 property" and "section 1250 property" have the meanings given such terms by sections 1245(a)(3) and 1250(c), respectively.

(13) Single purpose agricultural or horticultural structure

(A) In general

The term "single purpose agricultural or horticultural structure" means—

(i) a single purpose livestock structure, and

(ii) a single purpose horticultural structure.

(B) Definitions

For purposes of this paragraph—

(i) Single purpose livestock structure

The term "single purpose livestock structure" means any enclosure or structure specifically designed, constructed, and used—

(I) for housing, raising, and feeding a particular type of livestock and their produce, and

(II) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subclause (I).

(ii) Single purpose horticultural structure

The term "single purpose horticultural structure" means—

(I) a greenhouse specifically designed, constructed, and used for the commercial production of plants, and

(II) a structure specifically designed, constructed, and used for the commercial production of mushrooms.

(iii) Structures which include work space

An enclosure or structure which provides work space shall be treated as a single purpose agricultural or horticultural structure only if such work space is solely for—

(I) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce,

(II) the maintenance of the enclosure or structure, and

(III) the maintenance or replacement of the equipment or stock enclosed or housed therein.

(iv) Livestock

The term “livestock” includes poultry.

(14) Qualified rent-to-own property

(A) In general

The term “qualified rent-to-own property” means property held by a rent-to-own dealer for purposes of being subject to a rent-to-own contract.

(B) Rent-to-own dealer

The term “rent-to-own dealer” means a person that, in the ordinary course of business, regularly enters into rent-to-own contracts with customers for the use of consumer property, if a substantial portion of those contracts terminate and the property is returned to such person before the receipt of all payments required to transfer ownership of the property from such person to the customer.

(C) Consumer property

The term “consumer property” means tangible personal property of a type generally used within the home for personal use.

(D) Rent-to-own contract

The term “rent-to-own contract” means any lease for the use of consumer property between a rent-to-own dealer and a customer who is an individual which—

(i) is titled “Rent-to-Own Agreement” or “Lease Agreement with Ownership Option,” or uses other similar language,

(ii) provides for level (or decreasing where no payment is less than 40 percent of the largest payment), regular periodic payments (for a payment period which is a week or month),

(iii) provides that legal title to such property remains with the rent-to-own dealer until the customer makes all the payments described in clause (ii) or early purchase payments required under the contract to acquire legal title to the item of property,

(iv) provides a beginning date and a maximum period of time for which the contract may be in effect that does not exceed 156 weeks or 36 months from such beginning date (including renewals or options to extend),

(v) provides for payments within the 156-week or 36-month period that, in the aggregate, generally exceed the normal retail price of the consumer property plus interest,

(vi) provides for payments under the contract that, in the aggregate, do not exceed $10,000 per item of consumer property,

(vii) provides that the customer does not have any legal obligation to make all the payments referred to in clause (ii) set forth under the contract, and that at the end of each payment period the customer may either continue to use the consumer property by making the payment for the next payment period or return such property to the rent-to-own dealer in good working order, in which case the customer does not incur any further obligations under the contract and is not entitled to a return of any payments previously made under the contract, and

(viii) provides that the customer has no right to sell, sublease, mortgage, pawn, pledge, encumber, or otherwise dispose of the consumer property until all the payments stated in the contract have been made.

(15) Motorsports entertainment complex

(A) In general

The term “motorsports entertainment complex” means a racing track facility which—

(i) is permanently situated on land, and

(ii) during the 36-month period following the first day of the month in which the asset is placed in service, hosts 1 or more racing events for automobiles (of any type), trucks, or motorcycles which are open to the public for the price of admission.

(B) Ancillary and support facilities

Such term shall include, if owned by the taxpayer who owns the complex and provided for the benefit of patrons of the complex—

(i) ancillary facilities and land improvements in support of the complex’s activities (including parking lots, sidewalks, waterways, bridges, fences, and landscaping),

(ii) support facilities (including food and beverage retailing, souvenir vending, and other nonlodging accommodations), and

(iii) appurtenances associated with such facilities and related attractions and amusements (including ticket booths, race track surfaces, suites and hospitality facilities, grandstands and viewing structures, props, walls, facilities that support the delivery of entertainment services, other special purpose structures, facades, shop interiors, and buildings).

(C) Exception

Such term shall not include any transportation equipment, administrative services assets, warehouses, administrative buildings, hotels, or motels.

(D) Termination

Such term shall not include any property placed in service after December 31, 2025.

(16) Alaska natural gas pipeline

The term “Alaska natural gas pipeline” means the natural gas pipeline system located in the State of Alaska which—

(A) has a capacity of more than 500,000,000,000 Btu of natural gas per day, and

(B) is—

(i) placed in service after December 31, 2013, or

(ii) treated as placed in service on January 1, 2014, if the taxpayer who places such system in service before January 1, 2014, elects such treatment.

Such term includes the pipe, trunk lines, related equipment, and appurtenances used to carry natural gas, but does not include any gas processing plant.

(17) Natural gas gathering line

The term "natural gas gathering line" means—

(A) the pipe, equipment, and appurtenances determined to be a gathering line by the Federal Energy Regulatory Commission, and

(B) the pipe, equipment, and appurtenances used to deliver natural gas from the wellhead or a commonpoint to the point at which such gas first reaches—

(i) a gas processing plant,

(ii) an interconnection with a transmission pipeline for which a certificate as an interstate transmission pipeline has been issued by the Federal Energy Regulatory Commission,

(iii) an interconnection with an intrastate transmission pipeline, or

(iv) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

(18) Qualified smart electric meters

(A) In general

The term "qualified smart electric meter" means any smart electric meter which—

(i) is placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services, and

(ii) does not have a class life (determined without regard to subsection (e)) of less than 16 years.

(B) Smart electric meter

For purposes of subparagraph (A), the term "smart electric meter" means any time-based meter and related communication equipment which is capable of being used by the taxpayer as part of a system that—

(i) measures and records electricity usage data on a time-differentiated basis in at least 24 separate time segments per day,

(ii) provides for the exchange of information between supplier or provider and the customer's electric meter in support of time-based rates or other forms of demand response,

(iii) provides data to such supplier or provider so that the supplier or provider can provide energy usage information to customers electronically, and

(iv) provides net metering.

(19) Qualified smart electric grid systems

(A) In general

The term "qualified smart electric grid system" means any smart grid property which—

(i) is used as part of a system for electric distribution grid communications, monitoring, and management placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services, and

(ii) does not have a class life (determined without regard to subsection (e)) of less than 16 years.

(B) Smart grid property

For the purposes of subparagraph (A), the term “smart grid property” means electronics and related equipment that is capable of—

(i) sensing, collecting, and monitoring data of or from all portions of a utility’s electric distribution grid,

(ii) providing real-time, two-way communications to monitor or manage such grid, and

(iii) providing real time analysis of and event prediction based upon collected data that can be used to improve electric distribution system reliability, quality, and performance.

§ 197. Amortization of goodwill and certain other intangibles

(a) General rule

A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

(f) Special rules

(1) Treatment of certain dispositions, etc.

(A) In general

If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained—

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i).

(B) Special rule for covenants not to compete

In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E), in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

(C) Special rule

All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of this paragraph.

(2) Treatment of certain transfers

(A) In general

In the case of any section 197 intangible transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

(B) Transactions covered

The transactions described in this subparagraph are—

(i) any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(3) Treatment of amounts paid pursuant to covenants not to compete, etc.

Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account.

(4) Treatment of franchises, etc.

(A) Franchise

The term “franchise” has the meaning given to such term by section 1253(b)(1).

(B) Treatment of renewals

Any renewal of a franchise, trademark, or trade name (or of a license, a permit, or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

(C) Certain amounts not taken into account

Any amount to which section 1253(d)(1) applies shall not be taken into account under this section.

(5) Treatment of certain reinsurance transactions

In the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under this section shall be the excess of—

(A) the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over

(B) the amount required to be capitalized under section 848 in connection with such transaction.

Subsection (b) shall not apply to any amount required to be capitalized under section 848.

(6) Treatment of certain subleases

For purposes of this section, a sublease shall be treated in the same manner as a lease of the underlying property involved.

(7) Treatment as depreciable

For purposes of this chapter, any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167.

(8) Treatment of certain increments in value

This section shall not apply to any increment in value if, without regard to this section, such increment is properly taken into account in determining the cost of property which is not a section 197 intangible.

(9) Anti-churning rules

For purposes of this section—

(A) In general

The term “amortizable section 197 intangible” shall not include any section 197 intangible which is described in subparagraph (A) or (B) of subsection (d)(1) (or for which depreciation or amortization would not have been allowable but for this section) and which is acquired by the taxpayer after the date of the enactment of this section, if—

(i) the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

(ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

(iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

For purposes of this subparagraph, the determination of whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary. For purposes of this subparagraph, deductions allowable under section 1253(d) shall be treated as deductions allowable for amortization.

(B) Exception where gain recognized

If—

(i) subparagraph (A) would not apply to an intangible acquired by the taxpayer but for the last sentence of subparagraph (C)(i), and

(ii) the person from whom the taxpayer acquired the intangible elects, notwithstanding any other provision of this title—

(I) to recognize gain on the disposition of the intangible, and

(II) to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest rate of income tax applicable to such person under this title,

then subparagraph (A) shall apply to the intangible only to the extent that the taxpayer’s adjusted basis in the intangible exceeds the gain recognized under clause (ii)(I).

(C) Related person defined

For purposes of this paragraph—

(i) Related person

A person (hereinafter in this paragraph referred to as the “related person”) is related to any person if—

(I) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or

(II) the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)).

For purposes of subclause (I), in applying section 267(b) or 707(b)(1), “20 percent” shall be substituted for “50 percent”.

(ii) Time for making determination

A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

(D) Acquisitions by reason of death

Subparagraph (A) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a).

(E) Special rule for partnerships

With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under this paragraph shall be made at the partner level and each partner shall be treated as having owned and used such partner’s proportionate share of the partnership assets.

(F) Anti-abuse rules

The term “amortizable section 197 intangible” does not include any section 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A).

(10) Tax-exempt use property subject to lease

In the case of any section 197 intangible which would be tax-exempt use property as defined in subsection (h) of section 168 if such section applied to such intangible, the amortization period under this section shall not be less than 125 percent of the lease term (within the meaning of section 168(i)(3)).

§ 199A. Qualified business income

(a) Allowance of deduction

In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the lesser of—

(1) the combined qualified business income amount of the taxpayer, or

(2) an amount equal to 20 percent of the excess (if any) of—

(A) the taxable income of the taxpayer for the taxable year, over

(B) the net capital gain (as defined in section 1(h)) of the taxpayer for such taxable year.

(b) Combined qualified business income amount

For purposes of this section—

(1) In general

The term "combined qualified business income amount" means, with respect to any taxable year, an amount equal to—

(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

(2) Determination of deductible amount for each trade or business

The amount determined under this paragraph with respect to any qualified trade or business is the lesser of—

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) the greater of—

(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

(3) Modifications to limit based on taxable income

(A) Exception from limit

In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).

(B) Phase-in of limit for certain taxpayers

(i) In general

If—

(I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and

(II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,

then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

(ii) Amount of reduction

The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as—

(I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to

(II) $50,000 ($100,000 in the case of a joint return).

(iii) Excess amount

For purposes of clause (ii), the excess amount is the excess of—

(I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

(4) Wages, etc.

(A) In general

The term "W–2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

(B) Limitation to wages attributable to qualified business income

Such term shall not include any amount which is not properly allocable to qualified business income for purposes of subsection (c)(1).

(C) Return requirement

Such term shall not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.

(5) Acquisitions, dispositions, and short taxable years

The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.

(6) Qualified property

For purposes of this section:

(A) In general

The term "qualified property" means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167—

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

(B) Depreciable period

The term "depreciable period" means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of—

(i) the date that is 10 years after such date, or

(ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).

(7) Special rule with respect to income received from cooperatives

In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the amount determined under paragraph (2) with respect to such trade or business shall be reduced by the lesser of—

(A) 9 percent of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or

(B) 50 percent of so much of the W–2 wages with respect to such trade or business as are so allocable.

(c) Qualified business income

For purposes of this section—

(1) In general

The term "qualified business income" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends or qualified publicly traded partnership income.

(2) Carryover of losses

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.

(3) Qualified items of income, gain, deduction, and loss

For purposes of this subsection—

(A) In general

The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are—

(i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a [1] foreign corporation" each place it appears), and

(ii) included or allowed in determining taxable income for the taxable year.

(B) Exceptions

The following items shall not be taken into account as a qualified item of income, gain, deduction, or loss:

(i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

(ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G). Any amount described in section 1385(a)(1) shall not be treated as described in this clause.

(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

(4) Treatment of reasonable compensation and guaranteed payments

Qualified business income shall not include—

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

(d) Qualified trade or business

For purposes of this section—

(1) In general

The term "qualified trade or business" means any trade or business other than—

(A) a specified service trade or business, or

(B) the trade or business of performing services as an employee.

(2) Specified service trade or business

The term “specified service trade or business” means any trade or business—

(A) which is described in section 1202(e)(3)(A) (applied without regard to the words “engineering, architecture,”) or which would be so described if the term “employees or owners” were substituted for “employees” therein, or

(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

(3) Exception for specified service businesses based on taxpayer’s income

(A) In general

If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), then—

(i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

(ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W–2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W–2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

(B) Applicable percentage

For purposes of subparagraph (A), the term “applicable percentage” means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of—

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $50,000 ($100,000 in the case of a joint return).

(e) Other definitions

For purposes of this section—

(1) Taxable income

Except as otherwise provided in subsection (g)(2)(B), taxable income shall be computed without regard to any deduction allowable under this section.

(2) Threshold amount

(A) In general

The term “threshold amount” means $157,500 (200 percent of such amount in the case of a joint return).

(B) Inflation adjustment

In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section

1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2017” for “calendar year 2016” in subparagraph (A)(ii) thereof.

The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

(3) Qualified REIT dividend

The term “qualified REIT dividend” means any dividend from a real estate investment trust received during the taxable year which—

(A) is not a capital gain dividend, as defined in section 857(b)(3), and

(B) is not qualified dividend income, as defined in section 1(h)(11).

(4) Qualified publicly traded partnership income

The term “qualified publicly traded partnership income” means, with respect to any qualified trade or business of a taxpayer, the sum of—

(A) the net amount of such taxpayer’s allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) [2] which is not treated as a corporation under section 7704(c), plus

(B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

(f) Special rules

(1) Application to partnerships and S corporations

(A) In general

In the case of a partnership or S corporation—

(i) this section shall be applied at the partner or shareholder level,

(ii) each partner or shareholder shall take into account such person’s allocable share of each qualified item of income, gain, deduction, and loss, and

(iii) each partner or shareholder shall be treated for purposes of subsection (b) as having W–2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person’s allocable share of the W–2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

For purposes of clause (iii), a partner’s or shareholder’s allocable share of W–2 wages shall be determined in the same manner as the partner’s or shareholder’s allocable share of wage expenses. For purposes of such clause, partner’s or shareholder’s allocable share of the unadjusted basis immediately after acquisition of qualified property shall be determined in the same manner as the partner’s or shareholder’s allocable share of depreciation. For purposes of this subparagraph, in the case of an S corporation, an allocable share shall be the shareholder's pro rata share of an item.

(B) Application to trusts and estates

Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W–2 wages shall apply to the apportionment of W–2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

(C) Treatment of trades or business in Puerto Rico

(i) In general

In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

(ii) Special rule for applying limit

In the case of any taxpayer described in clause (i), the determination of W–2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

(2) Coordination with minimum tax

For purposes of determining alternative minimum taxable income under section 55, qualified business income shall be determined without regard to any adjustments under sections 56 through 59.

(3) Deduction limited to income taxes

The deduction under subsection (a) shall only be allowed for purposes of this chapter.

(4) Regulations

The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations—

(A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and

(B) for the application of this section in the case of tiered entities.

(g) Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives

(1) Allowance of deduction

(A) In general

In the case of a taxpayer which is a specified agricultural or horticultural cooperative, there shall be allowed as a deduction an amount equal to 9 percent of the lesser of—

(i) the qualified production activities income of the taxpayer for the taxable year, or

(ii) the taxable income of the taxpayer for the taxable year.

(B) Limitation

(i) In general

The deduction allowable under subparagraph (A) for any taxable year shall not exceed 50 percent of the W–2 wages of the taxpayer for the taxable year.

(ii) W–2 wages

For purposes of this subparagraph, the W–2 wages of the taxpayer shall be determined in the same manner as under subsection (b)(4) (without regard to subparagraph (B) thereof and after application of subsection (b)(5)), except that such wages shall not include any amount which is not properly allocable to domestic production gross receipts for purposes of paragraph (3)(A).

(C) Taxable income of cooperatives determined without regard to certain deductions

For purposes of this subsection, the taxable income of a specified agricultural or horticultural cooperative shall be computed without regard to any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

(2) Deduction allowed to patrons

(A) In general

In the case of any eligible taxpayer who receives a qualified payment from a specified agricultural or horticultural cooperative, there shall be allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the deduction allowed under paragraph (1) to such cooperative which is—

(i) allowed with respect to the portion of the qualified production activities income to which such payment is attributable, and

(ii) identified by such cooperative in a written notice mailed to such taxpayer during the payment period described in section 1382(d).

(B) Limitation based on taxable income

The deduction allowed to any taxpayer under this paragraph shall not exceed the taxable income of the taxpayer determined without regard to the deduction allowed under this paragraph and after taking into account any deduction allowed to the taxpayer under subsection (a) for the taxable year.

(C) Cooperative denied deduction for portion of qualified payments

The taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any qualified payment as does not exceed the deduction allowable under subparagraph (A) with respect to such payment.

(D) Eligible taxpayer

For purposes of this paragraph, the term “eligible taxpayer” means—

(i) a taxpayer other than a corporation, or

(ii) a specified agricultural or horticultural cooperative.

(E) Qualified payment

For purposes of this section, the term “qualified payment” means, with respect to any eligible taxpayer, any amount which—

(i) is described in paragraph (1) or (3) of section 1385(a),

(ii) is received by such taxpayer from a specified agricultural or horticultural cooperative, and

(iii) is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative under paragraph (1).

(3) Qualified production activities income

For purposes of this subsection—

(A) In general

The term “qualified production activities income” for any taxable year means an amount equal to the excess (if any) of—

(i) the taxpayer’s domestic production gross receipts for such taxable year, over

(ii) the sum of—

(I) the cost of goods sold that are allocable to such receipts, and

(II) other expenses, losses, or deductions (other than the deduction allowed under this subsection), which are properly allocable to such receipts.

(B) Allocation method

The Secretary shall prescribe rules for the proper allocation of items described in subparagraph (A) for purposes of determining qualified production activities income. Such rules shall provide for the proper allocation of items whether or not such items are directly allocable to domestic production gross receipts.

(C) Special rules for determining costs

(i) In general

For purposes of determining costs under subclause (I) of subparagraph (A)(ii), any item or service brought into the United States shall be treated as acquired by purchase, and its cost shall be treated as not less than its value immediately after it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts.

(ii) Exports for further manufacture

In the case of any property described in clause (i) that had been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis under clause (i) shall not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture.

(D) Domestic production gross receipts

(i) In general

The term “domestic production gross receipts” means the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product which was manufactured, produced, grown, or extracted by the taxpayer (determined after the application of paragraph (4)(B)) in whole or significant part within the United States. Such term shall not include gross receipts of the taxpayer which are derived from the lease, rental, license, sale, exchange, or other disposition of land.

(ii) Related persons

(I) In general

The term “domestic production gross receipts” shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

(II) Related person

For purposes of subclause (I), a person shall be treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (*o*) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

(4) Specified agricultural or horticultural cooperative

For purposes of this section—

(A) In general

The term “specified agricultural or horticultural cooperative” means an organization to which part I of subchapter T applies which is engaged—

(i) in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or

(ii) in the marketing of agricultural or horticultural products.

(B) Application to marketing cooperatives

A specified agricultural or horticultural cooperative described in subparagraph (A)(ii) shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural product marketed by the specified agricultural or horticultural cooperative which its patrons have so manufactured, produced, grown, or extracted.

(5) Definitions and special rules

(A) Special rule for affiliated groups

(i) In general

All members of an expanded affiliated group shall be treated as a single corporation for purposes of this subsection.

(ii) Partnerships owned by expanded affiliated groups

For purposes of paragraph (3)(D), if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group shall be treated as a single taxpayer during such period.

(iii) Expanded affiliated group

For purposes of this subsection, the term "expanded affiliated group" means an affiliated group as defined in section 1504(a), determined—

(I) by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and

(II) without regard to paragraphs (2) and (4) of section 1504(b).

(iv) Allocation of deduction

Except as provided in regulations, the deduction under paragraph (1) shall be allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of qualified production activities income.

(B) Special rule for cooperative partners

In the case of a specified agricultural or horticultural cooperative which is a partner in a partnership, rules similar to the rules of subsection (f)(1) shall apply for purposes of this subsection.

(C) Trade or business requirement

This subsection shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business.

(D) Unrelated business taxable income

For purposes of determining the tax imposed by section 511, this section shall be applied by substituting “unrelated business taxable income” for “taxable income” each place it appears in this section (other than this subparagraph).

(E) Special rule for cooperative with oil related qualified production activities income

(i) In general

If a specified agricultural or horticultural cooperative has oil related qualified production activities income for any taxable year, the amount otherwise allowable as a deduction under paragraph (1) shall be reduced by 3 percent of the least of—

(I) the oil related qualified production activities income of the cooperative for the taxable year,

(II) the qualified production activities income of the cooperative for the taxable year, or

(III) taxable income.

(ii) Oil related qualified production activities income

For purposes of this subparagraph, the term “oil related qualified production activities income” means for any taxable year the qualified production activities income which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C), as in effect before its repeal) during such taxable year.

(6) Regulations

The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this subsection, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this subsection with respect to any activity described in paragraph (3)(D)(i). Such regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal).

(h) Anti-abuse rules

The Secretary shall—

(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

(i) Termination

This section shall not apply to taxable years beginning after December 31, 2025.

§ 267. Losses, expenses, and interest with respect to transactions between related taxpayers

(a) In general

(1) Deduction for losses disallowed

No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

(2) Matching of deduction and payee income item in the case of expenses and interest

If—

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

(3) Payments to foreign persons

(A) In general

The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

(B) Special rule for certain foreign entities

(i) In general

Notwithstanding subparagraph (A), in the case of any item payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) Secretarial authority

The Secretary may by regulation exempt

transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.

(b) Relationships

The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own—

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

(c) Constructive ownership of stock

For purposes of determining, in applying subsection (b), the ownership of stock—

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

(e) Special rules for pass-thru entities

(1) In general

In the case of any amount paid or incurred by, to, or on behalf of, a pass-thru entity, for purposes of applying subsection (a)(2)—

(A) such entity,

(B) in the case of—

(i) a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership, or

(ii) an S corporation, any person who owns (directly or indirectly) any of the stock of such corporation,

(C) any person who owns (directly or indirectly) any capital interest or profits interest of a partnership in which such entity owns (directly or indirectly) any capital interest or profits interest, and

(D) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to a person described in subparagraph (B) or (C),

shall be treated as persons specified in a paragraph of subsection (b). Subparagraph (C) shall apply to a transaction only if such transaction is related either to the operations of the partnership described in such subparagraph or to an interest in such partnership.

(2) Pass-thru entity

For purposes of this section, the term “pass-thru entity” means—

(A) a partnership, and

(B) an S corporation.

(3) Constructive ownership in the case of partnerships

For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles of subsection (c) shall apply, except that—

(A) paragraph (3) of subsection (c) shall not apply, and

(B) interests owned (directly or indirectly) by or for a C corporation shall be considered as owned by or for any shareholder only if such shareholder owns (directly or indirectly) 5 percent or more in value of the stock of such corporation.

(4) Subsection (a)(2) not to apply to certain guaranteed payments of partnerships

In the case of any amount paid or incurred by a partnership, subsection (a)(2) shall not apply to the extent that section 707(c) applies to such amount.

(5) Exception for certain expenses and interest of partnerships owning low-income housing

(A) In general

This subsection shall not apply with respect to qualified expenses and interest paid or incurred by a partnership owning low-income housing to—

(i) any qualified 5-percent or less partner of such partnership, or

(ii) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to any qualified 5-percent or less partner of such partnership.

(B) Qualified 5-percent or less partner

For purposes of this paragraph, the term "qualified 5-percent or less partner" means any partner who has (directly or indirectly) an interest of 5 percent or less in the aggregate capital and profits interests of the partnership but only if—

(i) such partner owned the low-income housing at all times during the 2-year period ending on the date such housing was transferred to the partnership, or

(ii) such partnership acquired the low-income housing pursuant to a purchase, assignment, or other transfer from the Department of Housing and Urban Development or any State or local housing authority.

For purposes of the preceding sentence, a partner shall be treated as holding any interest in the partnership which is held (directly or indirectly) by any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to such partner.

(C) Qualified expenses and interest

For purpose of this paragraph, the term "qualified expenses and interest" means any expense or interest incurred by the partnership with respect to low-income housing held by the partnership but—

(i) only if the amount of such expense or interest (as the case may be) is unconditionally required to be paid by the partnership not later than 10 years after the date such amount was incurred, and

(ii) in the case of such interest, only if such interest is incurred at an annual rate not in excess of 12 percent.

(D) Low-income housing

For purposes of this paragraph, the term "low-income housing" means—

(i) any interest in property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B), and

(ii) any interest in a partnership owning such property.

(6) Cross reference

For additional rules relating to partnerships, see section 707(b).

§ 444. Election of taxable year other than required taxable year

(a) General rule

Except as otherwise provided in this section, a partnership, S corporation, or personal service corporation may elect to have a taxable year other than the required taxable year.

(b) Limitations on taxable years which may be elected

(1) In general

Except as provided in paragraphs (2) and (3), an election may be made under subsection (a) only if the deferral period of the taxable year elected is not longer than 3 months.

(2) Changes in taxable year

Except as provided in paragraph (3), in the case of an entity changing a taxable year, an election may be made under subsection (a) only if the deferral period of the taxable year elected is not longer than the shorter of—

(A) 3 months, or

(B) the deferral period of the taxable year which is being changed.

(3) Special rule for entities retaining 1986 taxable years

In the case of an entity's 1st taxable year beginning after December 31, 1986, an entity may elect a taxable year under subsection (a) which is the same as the entity's last taxable year beginning in 1986.

(4) Deferral period

For purposes of this subsection, except as provided in regulations, the term "deferral period" means, with respect to any taxable year of the entity, the months between—

(A) the beginning of such year, and

(B) the close of the 1st required taxable year ending within such year.

§ 448. Limitation on use of cash method of accounting

(a) General rule

Except as otherwise provided in this section, in the case of a—

(1) C corporation,

(2) partnership which has a C corporation as a partner, or

(3) tax shelter,

taxable income shall not be computed under the cash receipts and disbursements method of accounting.

(b) Exceptions

(1) Farming business

Paragraphs (1) and (2) of subsection (a) shall not apply to any farming business.

(2) Qualified personal service corporations

Paragraphs (1) and (2) of subsection (a) shall not apply to a qualified personal service corporation, and such a corporation shall be treated as an individual for purposes of determining whether paragraph (2) of subsection (a) applies to any partnership.

(3) Entities which meet gross receipts test

Paragraphs (1) and (2) of subsection (a) shall not apply to any corporation or partnership for any taxable year if such entity (or any predecessor) meets the gross receipts test of subsection (c) for such taxable year.

§ 701. Partners, not partnership, subject to tax

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

§ 702. Income and credits of partner

(a) General rule

In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,

(2) gains and losses from sales or exchanges of capital assets held for more than 1 year,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170(c)),

(5) dividends with respect to which section 1(h)(11) or part VIII of subchapter B applies,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and

(8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) Character of items constituting distributive share

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) 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.

(c) Gross income of a partner

In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

(d) Cross reference

For rules relating to procedures for determining the tax treatment of partnership items see subchapter C of chapter 63 (section 6221 and following).

§ 703. Partnership computations

(a) Income and deductions

The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702(a) shall be separately stated, and

(2) the following deductions shall not be allowed to the partnership:

(A) the deductions for personal exemptions provided in section 151,

(B) the deduction for taxes provided in section 164(a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(C) the deduction for charitable contributions provided in section 170,

(D) the net operating loss deduction provided in section 172,

(E) the additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following), and

(F) the deduction for depletion under section 611 with respect to oil and gas wells.

(b) Elections of the partnership

Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under—

(1) subsection (b)(5) or (c)(3) of section 108 (relating to income from discharge of indebtedness),

(2) section 617 (relating to deduction and recapture of certain mining exploration expenditures), or

(3) section 901 (relating to taxes of foreign countries and possessions of the United States),

shall be made by each partner separately.

§ 704. Partner's distributive share

(a) Effect of partnership agreement

A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of distributive share

A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

(c) Contributed property

(1) In general

Under regulations prescribed by the Secretary—

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution,

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed—

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph, and

(C) if any property so contributed has a built-in loss—

(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution.

(2) Special rule for distributions where gain or loss would not be recognized outside partnerships

Under regulations prescribed by the Secretary, if—

(A) property contributed by a partner (hereinafter referred to as the "contributing partner") is distributed by the partnership to another partner, and

(B) other property of a like kind (within the meaning of section 1031) is distributed by the partnership to the contributing partner not later than the earlier of—

(i) the 180th day after the date of the distribution described in subparagraph (A), or

(ii) the due date (determined with regard to extensions) for the contributing partner's return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs, then to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).

(3) Other rules

Under regulations prescribed by the Secretary, rules similar to the rules of paragraph (1) shall apply to contributions by a partner (using the cash receipts and disbursements method of accounting) of accounts payable and other accrued but unpaid items. Any reference in paragraph (1) or (2) to the contributing partner shall be treated as including a reference to any successor of such partner.

(d) Limitation on allowance of losses

(1) In general

A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.

(2) Carryover

Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

(3) Special rules

(A) In general

In determining the amount of any loss under paragraph (1), there shall be taken into account the partner's distributive share of amounts described in paragraphs (4) and (6) of section 702(a).

(B) Exception

In the case of a charitable contribution of property whose fair market value exceeds its adjusted basis, subparagraph (A) shall not apply to the extent of the partner's distributive share of such excess.

(e) Partnership interests created by gift

(1) Distributive share of donee includible in gross income

In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement 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 share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(2) Purchase of interest by member of family

For purposes of this subsection, an interest 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 shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

(f) Cross reference

For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see section 706(c)(2).

§ 705. Determination of basis of partner's interest

(a) General rule

The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—

(1) increased by the sum of his distributive share for the taxable year and prior taxable years of—

(A) taxable income of the partnership as determined under section 703(a),

(B) income of the partnership exempt from tax under this title, and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion;

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of—

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and

(3) decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under section 613A(c)(7)(D).

(b) Alternative rule

The Secretary shall prescribe by regulations the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.

§ 706. Taxable years of partner and partnership

(a) Year in which partnership income is includible

In computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

(b) Taxable year

(1) Partnership's taxable year

(A) Partnership treated as taxpayer

The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(B) Taxable year determined by reference to partners

Except as provided in subparagraph (C), a partnership shall not have a taxable year other than—

(i) the majority interest taxable year (as defined in paragraph (4)),

(ii) if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership, or

(iii) if there is no taxable year described in clause (i) or (ii), the calendar year unless the Secretary by regulations prescribes another period.

(C) Business purpose

A partnership may have a taxable year not described in subparagraph (B) if it establishes, to the satisfaction of the Secretary, a business purpose therefor. For purposes of this subparagraph, any deferral of income to partners shall not be treated as a business purpose.

(2) Partner's taxable year

A partner may not change to a taxable year other than that of a partnership in which he is a principal partner unless he establishes, to the satisfaction of the Secretary, a business purpose therefor.

(3) Principal partner

For the purpose of this subsection, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) Majority interest taxable year; limitation on required changes

(A) Majority interest taxable year defined

For purposes of paragraph (1)(B)(i)—

(i) In general

The term "majority interest taxable year" means the taxable year (if any) which, on each testing day, constituted the taxable year of 1 or more partners having (on such day) an aggregate interest in partnership profits and capital of more than 50 percent.

(ii) Testing days

The testing days shall be—

(I) the 1st day of the partnership taxable year (determined without regard to clause (i)), or

(II) the days during such representative period as the Secretary may prescribe.

(B) Further change not required for 3 years

Except as provided in regulations necessary to prevent the avoidance of this section, if, by reason of paragraph (1)(B)(i), the taxable year of a partnership is changed, such partnership shall not be required to change to another taxable year for either of the 2 taxable years following the year of change.

(5) Application with other sections

Except as provided in regulations, for purposes of determining the taxable year to which a partnership is required to change by reason of this subsection, changes in taxable years of other persons required by this subsection, section 441(i), section 584(i), section 644, or section 1378(a) shall be taken into account.

(c) Closing of partnership year

(1) General rule

Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, 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 interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

(2) Treatment of dispositions

(A) Disposition of entire interest

The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise).

(B) Disposition of less than entire interest

The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b)(1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise).

(d) Determination of distributive share when partner's interest changes

(1) In general

Except as provided in paragraphs (2) and (3), if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

(2) Certain cash basis items prorated over period to which attributable

(A) In general

If during any taxable year of the partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item shall be determined—

(i) by assigning the appropriate portion of such item to each day in the period to which it is attributable, and

(ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.

(B) Allocable cash basis item

For purposes of this paragraph, the term "allocable cash basis item" means any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting:

(i) Interest.

(ii) Taxes.

(iii) Payments for services or for the use of property.

(iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

(C) Items attributable to periods not within taxable year

If any portion of any allocable cash basis item is attributable to—

(i) any period before the beginning of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the first day of the taxable year, or

(ii) any period after the close of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the last day of the taxable year.

(D) Treatment of deductible items attributable to prior periods

If any portion of a deductible cash basis item is assigned under subparagraph (C)(i) to the first day of any taxable year—

(i) such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and

(ii) any amount allocated under clause (i) to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in section 755.

(3) Items attributable to interest in lower tier partnership prorated over entire taxable year

If—

(A) during any taxable year of the partnership there is a change in any partner's interest in the partnership (hereinafter in this paragraph referred to as the "upper tier partnership"), and

(B) such partnership is a partner in another partnership (hereinafter in this paragraph referred to as the "lower tier partnership"),

then (except to the extent provided in regulations) each partner's distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles of subparagraphs (C) and (D) of paragraph (2)) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.

(4) Taxable year determined without regard to subsection (c)(2)(A)

For purposes of this subsection, the taxable year of a partnership shall be determined without regard to subsection (c)(2)(A).

§ 707. Transactions between partner and partnership

(a) Partner not acting in capacity as partner

(1) In general

If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services

Under regulations prescribed by the Secretary—

(A) Treatment of certain services and transfers of property

If—

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership,

such allocation and distribution shall be treated as a transaction described in paragraph (1).

(B) Treatment of certain property transfers

If—

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

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

(1) Losses disallowed

No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—

(A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1). For purposes of section 267(a)(2), partnerships described in subparagraph (B) of this paragraph shall be treated as persons specified in section 267(b).

(2) Gains treated as ordinary income

In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221—

(A) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership, or

(B) between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests,

any gain recognized shall be considered as ordinary income.

(3) Ownership of a capital or profits interest

For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such section.

(c) Guaranteed payments

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

§ 708. Continuation of partnership

(a) General rule

For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination

(1) General rule

For purposes of subsection (a), a partnership shall be considered as terminated only if 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.

(2) Special rules

(A) Merger or consolidation

In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

(B) Division of a partnership

In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of this section, be considered a continuation of the prior partnership.

§ 721. Nonrecognition of gain or loss on contribution

(a) General rule

No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

(b) Special rule

Subsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.

(c) Regulations relating to certain transfers to partnerships

The Secretary may provide by regulations that subsection (a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person.

(d) Transfers of intangibles

For regulatory authority to treat intangibles transferred to a partnership as sold, see section 367(d)(3).

§ 722. Basis of contributing partner's interest

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

§ 723. Basis of property contributed to partnership

The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

§ 724. Character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property

(a) Contributions of unrealized receivables

In the case of any property which—

(1) was contributed to the partnership by a partner, and

(2) was an unrealized receivable in the hands of such partner immediately before such contribution, any gain or loss recognized by the partnership on the disposition of such property shall be treated as ordinary income or ordinary loss, as the case may be.

(b) Contributions of inventory items

In the case of any property which—

(1) was contributed to the partnership by a partner, and

(2) was an inventory item in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as ordinary income or ordinary loss, as the case may be.

(c) Contributions of capital loss property

In the case of any property which—

(1) was contributed by a partner to the partnership, and

(2) was a capital asset in the hands of such partner immediately before such contribution,

any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.

(d) Definitions

For purposes of this section—

(1) Unrealized receivable

The term “unrealized receivable” has the meaning given such term by section 751(c) (determined by treating any reference to the partnership as referring to the partner).

(2) Inventory item

The term “inventory item” has the meaning given such term by section 751(d) (determined by treating any reference to the partnership as referring to the partner and by applying section 1231 without regard to any holding period therein provided).

(3) Substituted basis property

(A) In general

If any property described in subsection (a), (b), or (c) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply to any substituted basis property resulting from such transaction. A similar rule shall also apply in the case of a series of non-recognition transactions.

(B) Exception for stock in C corporation

Subparagraph (A) shall not apply to any stock in a C corporation received in an exchange described in section 351.

§ 731. Extent of recognition of gain or loss on distribution

(a) Partners

In the case of a distribution by a partnership to a partner—

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

(b) Partnerships

No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

(c) Treatment of marketable securities

(1) In general

For purposes of subsection (a)(1) and section 737—

(A) the term "money" includes marketable securities, and

(B) such securities shall be taken into account at their fair market value as of the date of the distribution.

(2) Marketable securities

For purposes of this subsection:

(A) In general

The term "marketable securities" means financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of section 1092(d)(1)).

(B) Other property

Such term includes—

(i) any interest in—

(I) a common trust fund, or

(II) a regulated investment company which is offering for sale or has outstanding any redeemable security (as defined in section 2(a)(32) of the Investment Company Act of 1940) of which it is the issuer,

(ii) any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities,

(iii) any financial instrument the value of which is determined substantially by reference to marketable securities,

(iv) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal which, as of the date of the distribution, is actively traded (within the meaning of section 1092(d)(1)) unless such metal was produced, used, or held in the active conduct of a trade or business by the partnership,

(v) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both, and

(vi) to the extent provided in regulations prescribed by the Secretary, any interest in an entity not described in clause (v) but only to the extent of the value of such interest which is attributable to marketable securities, money, or both.

(C) Financial instrument

The term “financial instrument” includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

(3) Exceptions

(A) In general

Paragraph (1) shall not apply to the distribution from a partnership of a marketable security to a partner if—

(i) the security was contributed to the partnership by such partner, except to the extent that the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) to the entity to which the distributed security relates,

(ii) to the extent provided in regulations prescribed by the Secretary, the property was not a marketable security when acquired by such partnership, or

(iii) such partnership is an investment partnership and such partner is an eligible partner thereof.

(B) Limitation on gain recognized

In the case of a distribution of marketable securities to a partner, the amount taken into account under paragraph (1) shall be reduced (but not below zero) by the excess (if any) of—

(i) such partner’s distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed 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) such partner’s distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under clause (i).

Under regulations prescribed by the Secretary, all marketable securities held by the partnership may be treated as marketable securities of the same class and issuer as the distributed securities.

(C) Definitions relating to investment partnerships

For purposes of subparagraph (A)(iii):

(i) Investment partnership

The term “investment partnership” means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of—

(I) money,

(II) stock in a corporation,

(III) notes, bonds, debentures, or other evidences of indebtedness,

(IV) interest rate, currency, or equity notional principal contracts,

(V) foreign currencies,

(VI) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity traded on or subject to the rules of a board of trade or commodity exchange,

(VII) other assets specified in regulations prescribed by the Secretary, or

(VIII) any combination of the foregoing.

(ii) Exception for certain activities

A partnership shall not be 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 clause (i), or

(II) any other activity specified in regulations prescribed by the Secretary.

(iii) Eligible partner

(I) In general

The term “eligible partner” means any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in clause (i).

(II) Exception for certain nonrecognition transactions

The term “eligible partner” shall not include the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner.

(iv) Look-thru of partnership tiers

Except as otherwise provided in regulations prescribed by the Secretary—

(I) a partnership shall be treated as engaged in any trade or business engaged in by, and as holding (instead of a partnership interest) a proportionate share of the assets of, any other partnership in which the partnership holds a partnership interest, and

(II) a partner who contributes to a partnership an interest in another partnership shall be treated as contributing a proportionate share of the assets of the other partnership.

If the preceding sentence does not apply under such regulations with respect to any interest held by a partnership in another partnership, the interest in such other partnership shall be treated as if it were specified in a subclause of clause (i).

(4) Basis of securities distributed

(A) In general

The basis of marketable securities with respect to which gain is recognized by reason of this subsection shall be—

(i) their basis determined under section 732, increased by

(ii) the amount of such gain.

(B) Allocation of basis increase

Any increase in basis attributable to the gain described in subparagraph (A)(ii) shall be allocated to marketable securities in proportion to their respective amounts of unrealized appreciation before such increase.

(5) Subsection disregarded in determining basis of partner's interest in partnership and of basis of partnership property

Sections 733 and 734 shall be applied as if no gain were recognized, and no adjustment were made to the basis of property, under this subsection.

(6) Character of gain recognized

In the case of a distribution of a marketable security which is an unrealized receivable (as defined in section 751(c)) or an inventory item (as defined in section 751(d)), any gain recognized under this subsection shall be treated as ordinary income to the extent of any increase in the basis of such security attributable to the gain described in paragraph (4)(A)(ii).

(7) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations to prevent the avoidance of such purposes.

(d) Exceptions

This section shall not apply to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), section 751 (relating to unrealized receivables and inventory items), and section 737 (relating to recognition of precontribution gain in case of certain distributions).

§ 732. Basis of distributed property other than money

(a) Distributions other than in liquidation of a partner's interest

(1) General rule

The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

(2) Limitation

The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) Distributions in liquidation

The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(c) Allocation of basis

(1) In general

The basis of distributed properties to which subsection (a)(2) or (b) is applicable shall be allocated—

(A)

(i) first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)) in an amount equal to the adjusted basis of each such property to the partnership, and

(ii) if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, then, to the extent any decrease is required in order to have the adjusted bases of such properties equal the basis to be allocated, in the manner provided in paragraph (3), and

(B) to the extent of any basis remaining after the allocation under subparagraph (A), to other distributed properties—

(i) first by assigning to each such other property such other property's adjusted basis to the partnership, and

(ii) then, to the extent any increase or decrease in basis is required in order to have the adjusted bases of such other distributed properties equal such remaining basis, in the manner provided in paragraph (2) or (3), whichever is appropriate.

(2) Method of allocating increase

Any increase required under paragraph (1)(B) shall be allocated among the properties—

(A) 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), and

(B) then, to the extent such increase is not allocated under subparagraph (A), in proportion to their respective fair market values.

(3) Method of allocating decrease

Any decrease required under paragraph (1)(A) or (1)(B) shall be allocated—

(A) 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), and

(B) then, to the extent such decrease is not allocated under subparagraph (A), in proportion to their respective adjusted bases (as adjusted under subparagraph (A)).

(d) Special partnership basis to transferee

For purposes of subsections (a), (b), and (c), a partner who acquired all or a part of his interest by a transfer with respect to which the election provided in section 754 is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, may elect, under regulations prescribed by the Secretary, 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 with respect to the partnership property. The Secretary may by regulations require the application of this subsection in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(e) Exception

This section shall not apply to the extent that a distribution is treated as a sale or exchange of property under section 751(b) (relating to unrealized receivables and inventory items).

(f) Corresponding adjustment to basis of assets of a distributed corporation controlled by a corporate partner

(1) In general

If—

(A) a corporation (hereafter in this subsection referred to as the "corporate partner") receives a distribution from a partnership of stock in another corporation (hereafter in this subsection referred to as the "distributed corporation"),

(B) the corporate partner has control of the distributed corporation immediately after the distribution or at any time thereafter, and

(C) the partnership's adjusted basis in such stock immediately before the distribution exceeded the corporate partner's adjusted basis in such stock immediately after the distribution,

then an amount equal to such excess shall be applied to reduce (in accordance with subsection (c)) the basis of property held by the distributed corporation at such time (or, if the corporate partner does not control the distributed corporation at such time, at the time the corporate partner first has such control).

(2) Exception for certain distributions before control acquired

Paragraph (1) shall not apply to any distribution of stock in the distributed corporation if—

(A) the corporate partner does not have control of such corporation immediately after such distribution, and

(B) the corporate partner establishes to the satisfaction of the Secretary that such distribution was not part of a plan or arrangement to acquire control of the distributed corporation.

(3) Limitations on basis reduction

(A) In general

The amount of the reduction under paragraph (1) shall not exceed the amount by which the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds the corporate partner’s adjusted basis in the stock of the distributed corporation.

(B) Reduction not to exceed adjusted basis of property

No reduction under paragraph (1) in the basis of any property shall exceed the adjusted basis of such property (determined without regard to such reduction).

(4) Gain recognition where reduction limited

If the amount of any reduction under paragraph (1) (determined after the application of paragraph (3)(A)) exceeds the aggregate adjusted bases of the property of the distributed corporation—

(A) such excess shall be recognized by the corporate partner as long-term capital gain, and

(B) the corporate partner’s adjusted basis in the stock of the distributed corporation shall be increased by such excess.

(5) Control

For purposes of this subsection, the term “control” means ownership of stock meeting the requirements of section 1504(a)(2).

(6) Indirect distributions

For purposes of paragraph (1), if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to subsection (a)(2) or (b), the corporation shall be treated as receiving a distribution of such stock from a partnership.

(7) Special rule for stock in controlled corporation

If the property held by a distributed corporation is stock in a corporation which the distributed corporation controls, this subsection shall be applied to reduce the basis of the property of such controlled corporation. This subsection shall be reapplied to any property of any controlled corporation which is stock in a corporation which it controls.

(8) Regulations

The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations to avoid double counting and to prevent the abuse of such purposes.

§ 733. 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 interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by—

(1) the amount of any money distributed to such partner, and

(2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

§ 734. Adjustment to basis of undistributed partnership property where section 754 election or substantial basis reduction

(a) General rule

The basis of partnership property shall not be adjusted 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 with respect to such partnership or unless there is a substantial basis reduction with respect to such distribution.

(b) Method of adjustment

In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall—

(1) increase the adjusted basis of partnership property by—

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732, or

(2) decrease the adjusted basis of partnership property by—

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2), and

(B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)).

Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect.

(c) Allocation of basis

The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

(d) Substantial basis reduction

(1) In general

For purposes of this section, there is a substantial basis reduction with respect to a distribution if the sum of the amounts described in subparagraphs (A) and (B) of subsection (b)(2) exceeds $250,000.

(2) Regulations

For regulations to carry out this subsection, see section 743(d)(2).

(e) Exception for securitization partnerships

For purposes of this section, a securitization partnership (as defined in section 743(f)) shall not be treated as having a substantial basis reduction with respect to any distribution of property to a partner.

§ 735. Character of gain or loss on disposition of distributed property

(a) Sale or exchange of certain distributed property

(1) Unrealized receivables

Gain or loss on the disposition by a distributee partner of unrealized receivables (as defined in section 751(c)) distributed by a partnership, shall be considered as ordinary income or as ordinary loss, as the case may be.

(2) Inventory items

Gain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751(d)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered as ordinary income or as ordinary loss, as the case may be.

(b) Holding period for distributed property

In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a)(2)), there shall be included the holding period of the partnership, as determined under section 1223, with respect to such property.

(c) Special rules

(1) Waiver of holding periods contained in section 1231

For purposes of this section, section 751(d) (defining inventory item) shall be applied without regard to any holding period in section 1231(b).

(2) Substituted basis property

(A) In general

If any property described in subsection (a) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply to any substituted basis property resulting from such transaction. A similar rule shall also apply in the case of a series of nonrecognition transactions.

(B) Exception for stock in C corporation

Subparagraph (A) shall not apply to any stock in a C corporation received in an exchange described in section 351.

§ 736. Payments to a retiring partner or a deceased partner’s successor in interest

(a) Payments considered as distributive share or guaranteed payment

Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) Payments for interest in partnership

(1) General rule

Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) Special rules

For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

(3) Limitation on application of paragraph (2)

Paragraph (2) shall apply only if—

(A) capital is not a material income-producing factor for the partnership, and

(B) the retiring or deceased partner was a general partner in the partnership.

§ 741. Recognition and character of gain or loss on sale or exchange

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

§ 742. Basis of transferee partner’s interest

The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter O (sec. 1011 and following).

§ 743. Special rules where section 754 election or substantial built-in loss

(a) General rule

The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership or unless the partnership has a substantial built-in loss immediately after such transfer.

(b) Adjustment to basis of partnership property

In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect or which has a substantial built-in loss immediately after such transfer shall—

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of property contributed to the partnership by a partner, section 704(c) (relating to contributed property) shall apply in determining such share. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

(c) Allocation of basis

The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

(d) Substantial built-in loss

(1) In general

For purposes of this section, a partnership has a substantial built-in loss with respect to a transfer of an interest in the partnership if—

(A) the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property, or

(B) the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer.

(2) Regulations

The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of paragraph (1) and section 734(d), including regulations aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes.

(e) Alternative rules for electing investment partnerships

(1) No adjustment of partnership basis

For purposes of this section, an electing investment partnership shall not be treated as having a substantial built-in loss with respect to any transfer occurring while the election under paragraph (6)(A) is in effect.

(2) Loss deferral for transferee partner

In the case of a transfer of an interest in an electing investment partnership, the transferee partner's distributive share of losses (without regard to gains) from the sale or exchange of partnership property shall not be allowed except to the extent that it is established that such losses exceed the loss (if any) recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this paragraph) on the transfer of the partnership interest.

(3) No reduction in partnership basis

Losses disallowed under paragraph (2) shall not decrease the transferee partner's basis in the partnership interest.

(4) Certain basis reductions treated as losses

In the case of a transferee partner whose basis in property distributed by the partnership is reduced under section 732(a)(2), the amount of the loss recognized by the transferor on the transfer of the partnership interest which is taken into account under paragraph (2) shall be reduced by the amount of such basis reduction.

(5) Electing investment partnership

For purposes of this subsection, the term "electing investment partnership" means any partnership if—

(A) the partnership makes an election to have this subsection apply,

(B) the partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of section 3(c) of such Act,

(C) such partnership has never been engaged in a trade or business,

(D) substantially all of the assets of such partnership are held for investment,

(E) at least 95 percent of the assets contributed to such partnership consist of money,

(F) no assets contributed to such partnership had an adjusted basis in excess of fair market value at the time of contribution,

(G) all partnership interests of such partnership are issued by such partnership pursuant to a private offering before the date which is 24 months after the date of the first capital contribution to such partnership,

(H) the partnership agreement of such partnership has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and

(I) the partnership agreement of such partnership provides for a term that is not in excess of 15 years.

The election described in subparagraph (A), once made, shall be irrevocable except with the consent of the Secretary.

(6) Regulations

The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including regulations for applying this subsection to tiered partnerships.

(f) Exception for securitization partnerships

(1) No adjustment of partnership basis

For purposes of this section, a securitization partnership shall not be treated as having a substantial built-in loss with respect to any transfer.

(2) Securitization partnership

For purposes of paragraph (1), the term “securitization partnership” means any partnership the sole business activity of which is to issue securities which provide for a fixed principal (or similar) amount and which are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets that by their terms convert into cash in a finite period, but only if the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired so as to be disposed of.

§ 751. Unrealized receivables and inventory items

(a) Sale or exchange of interest in partnership

The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

(b) Certain distributions treated as sales or exchanges

(1) General rule

To the extent a partner receives in a distribution—

(A) partnership property which is—

(i) unrealized receivables, or

(ii) inventory items which have appreciated substantially in value,

in exchange for all or a part of his interest in other partnership property (including money), or

(B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),

such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

(2) Exceptions

Paragraph (1) shall not apply to—

(A) a distribution of property which the distributee contributed to the partnership, or

(B) payments, described in section 736(a), to a retiring partner or successor in interest of a deceased partner.

(3) Substantial appreciation

For purposes of paragraph (1)—

(A) In general

Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property.

(B) Certain property excluded

For purposes of subparagraph (A), there shall be excluded any inventory property if a principal purpose for acquiring such property was to avoid the provisions of this subsection relating to inventory items.

(c) Unrealized receivables

For purposes of this subchapter, the term “unrealized receivables” includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—

(1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(2) services rendered, or to be rendered.

For purposes of this section and sections 731, 732, and 741 (but not for purposes of section 736), such term also includes mining property (as defined in section 617(f)(2)), stock in a DISC (as described in section 992(a)), section 1245 property (as defined in section 1245(a)(3)), stock in certain foreign corporations (as described in section 1248), section 1250 property (as defined in section 1250(c)), farm land (as defined in section 1252(a)), franchises, trademarks, or trade names (referred to in section 1253(a)), and an oil, gas, or geothermal property (described in section 1254) but only to the extent of the amount which would be treated as gain to which section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1252(a), 1253(a), or 1254(a) would apply if (at the time of the transaction described in this section or section 731, 732, or 741, as the case may be) such property had been sold by the partnership at its fair market value. For purposes of this section and sections 731, 732, and 741 (but not for purposes of section 736), such term also includes any market discount bond (as defined in section 1278) and any short-term obligation (as defined in section 1283) but only to the extent of the amount which would be treated as ordinary income if (at the time of the transaction described in this section or section 731, 732, or 741, as the case may be) such property had been sold by the partnership.

(d) Inventory items

For purposes of this subchapter, the term “inventory items” means—

(1) property of the partnership of the kind described in section 1221(a)(1),

(2) 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, and

(3) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in paragraph (1) or (2).

(e) Limitation on tax attributable to deemed sales of section 1248 stock

For purposes of applying this section and sections 731 and 741 to any amount resulting from the reference to section 1248(a) in the second sentence of subsection (c), in the case of an individual, the tax attributable to such amount shall be limited in the manner provided by subsection (b) of section 1248 (relating to gain from certain sales or exchanges of stock in certain foreign corporation).

(f) Special rules in the case of tiered partnerships, etc.

In determining whether property of a partnership is—

(1) an unrealized receivable, or

(2) an inventory item,

such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Under regulations, rules similar to the rules of the preceding sentence shall also apply in the case of interests in trusts.

§ 752. Treatment of certain liabilities

(a) Increase in partner's liabilities

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in partner's liabilities

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) Liability to which property is subject

For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) Sale or exchange of an interest

In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

§ 754. Manner of electing optional adjustment to basis of partnership property

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.

§ 755. Rules for allocation of basis

(a) General rule

Any increase or decrease in the adjusted basis of partnership property under section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership) shall, except as provided in subsection (b), be allocated—

(1) in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or

(2) in any other manner permitted by regulations prescribed by the Secretary.

(b) Special rule

In applying the allocation rules provided in subsection (a), increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, property consisting of—

(1) capital assets and property described in section 1231(b), or

(2) any other property of the partnership,

shall be allocated to partnership property of a like character except that the basis of any such partnership property shall not be reduced below zero. If, in the case of a distribution, the adjustment to basis of property described in paragraph (1) or (2) is prevented by the absence of such property or by insufficient adjusted basis for such property, such adjustment shall be applied to subsequently acquired property of a like character in accordance with regulations prescribed by the Secretary.

(c) No allocation of basis decrease to stock of corporate partner

In making an allocation under subsection (a) of any decrease in the adjusted basis of partnership property under section 734(b)—

(1) no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) and 707(b)(1)) to such corporation) which is a partner in the partnership, and

(2) any amount not allocable to stock by reason of paragraph (1) shall be allocated under subsection (a) to other partnership property.

Gain shall be recognized to the partnership to the extent that the amount required to be allocated under paragraph (2) to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the allocation required by paragraph (2).

§ 761. Terms defined

(a) Partnership

For purposes of this subtitle, the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) for investment purposes only and not for the active conduct of a business,

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or

(3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

(b) Partner

For purposes of this subtitle, the term “partner” means a member of a partnership. In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.

(c) Partnership agreement

For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

(d) Liquidation of a partner’s interest

For purposes of this subchapter, 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.

(e) Distributions of partnership interests treated as exchanges

Except as otherwise provided in regulations, for purposes of—

(1) section 708 (relating to continuation of partnership),

(2) section 743 (relating to optional adjustment to basis of partnership property), and

(3) any other provision of this subchapter specified in regulations prescribed by the Secretary,

any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

(f) Qualified joint venture

(1) In general

In the case of a qualified joint venture conducted by a husband and wife who file a joint return for the taxable year, for purposes of this title—

(A) such joint venture shall not be treated as a partnership,

(B) all items of income, gain, loss, deduction, and credit shall be divided between the spouses in accordance with their respective interests in the venture, and

(C) each spouse shall take into account such spouse’s respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor.

(2) Qualified joint venture

For purposes of paragraph (1), the term “qualified joint venture” means any joint venture involving the conduct of a trade or business if—

(A) the only members of such joint venture are a husband and wife,

(B) both spouses materially participate (within the meaning of section 469(h) without regard to paragraph (5) thereof) in such trade or business, and

(C) both spouses elect the application of this subsection.

(g) Cross reference

For rules in the case of the sale, exchange, liquidation, or reduction of a partner’s interest, see sections 704(b) and 706(c)(2).

§ 1061. Partnership interests held in connection with performance of services

(a) In general

If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of—

(1) the taxpayer’s net long-term capital gain with respect to such interests for such taxable year, over

(2) the taxpayer’s net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections [1] 1222 by substituting “3 years” for “1 year”,

shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).

(b) Special rule

To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

(c) Applicable partnership interest

For purposes of this section—

(1) In general

Except as provided in this paragraph or paragraph (4), the term “applicable partnership interest” means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. The previous sentence shall not apply to an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity.

(2) Applicable trade or business

The term “applicable trade or business” means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of—

(A) raising or returning capital, and

(B) either—

(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or

(ii) developing specified assets.

(3) Specified asset

The term "specified asset" means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), commodities (as defined in section 475(e)(2)), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

(4) Exceptions

The term "applicable partnership interest" shall not include—

(A) any interest in a partnership directly or indirectly held by a corporation, or

(B) any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with—

(i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or

(ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.

(5) Third party investor

The term "third party investor" means a person who—

(A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and

(B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services described in paragraph (1) for such partnership or any applicable trade or business.

(d) Transfer of applicable partnership interest to related person

(1) In general

If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short term capital gain) the excess (if any) of—

(A) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over

(B) any amount treated as short term capital gain under subsection (a) with respect to the transfer of such interest.

(2) Related person

For purposes of this paragraph, a person is related to the taxpayer if—

(A) the person is a member of the taxpayer's family within the meaning of section 318(a)(1), or

(B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

(e) Reporting

The Secretary shall require such reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of this section.

(f) Regulations

The Secretary shall issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this section [2]

§ 6031. Return of partnership income

(a) General rule

Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information, for the purpose of carrying out the provisions of subtitle A as the Secretary may by forms and regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.

(b) Copies to partners

Each partnership required to file a return under subsection (a) for any partnership taxable year shall (on or before the day on which the return for such taxable year was required to be filed) furnish to each person who is a partner or who holds an interest in such partnership as a nominee for another person at any time during such taxable year a copy of such information required to be shown on such return as may be required by regulations. Information required to be furnished by the partnership under this subsection may not be amended after the due date of the return under subsection (a) to which such information relates, except—

(1) in the case of a partnership which has elected the application of section 6221(b) for the taxable year,

(2) as provided in the procedures under section 6225(c),

(3) with respect to statements under section 6226, or

(4) as otherwise provided by the Secretary.

(c) Nominee reporting

Any person who holds an interest in a partnership as a nominee for another person—

(1) shall furnish to the partnership, in the manner prescribed by the Secretary, the name and address of such other person, and any other information for such taxable year as the Secretary may by form and regulation prescribe, and

(2) shall furnish in the manner prescribed by the Secretary such other person the information provided by such partnership under subsection (b).

(d) Separate statement of items of unrelated business taxable income

In the case of any partnership regularly carrying on a trade or business (within the meaning of section 512(c)(1)), the information required under subsection (b) to be furnished to its partners shall include such information as is necessary to enable each partner to compute its distributive share of partnership income or loss from such trade or business in accordance with section 512(a)(1), but without regard to the modifications described in paragraphs (8) through (15) of section 512(b).

(e) Foreign partnerships

(1) Exception for foreign partnership

Except as provided in paragraph (2), the preceding provisions of this section shall not apply to a foreign partnership.

(2) Certain foreign partnerships required to file return

Except as provided in regulations prescribed by the Secretary, this section shall apply to a foreign partnership for any taxable year if for such year, such partnership has—

(A) gross income derived from sources within the United States, or

(B) gross income which is effectively connected with the conduct of a trade or business within the United States.

The Secretary may provide simplified filing procedures for foreign partnerships to which this section applies.

(f) Electing investment partnerships

In the case of any electing investment partnership (as defined in section 743(e)(6)),[1] the information required under subsection (b) to be furnished to any partner to whom section 743(e)(2) applies shall include such information as is necessary to enable the partner to compute the amount of losses disallowed under section 743(e).

§ 6698. Failure to file partnership return

(a) General rule

In addition to the penalty imposed by section 7203 (relating to willful failure to file return, supply information, or pay tax), if any partnership required to file a return under section 6031, or a partnership adjustment tracking report under section 6226(b)(4)(A), for any taxable year—

(1) fails to file such return, or such report, at the time prescribed therefor (determined with regard to any extension of time for filing), or

(2) files a return or a report which fails to show the information required under section 6031 or 6226(b)(4)(A), respectively,

such partnership shall be liable for a penalty determined under subsection (b) for each month (or fraction thereof) during which such failure continues (but not to exceed 12 months), unless it is shown that such failure is due to reasonable cause.

(b) Amount per month

For purposes of subsection (a), the amount determined under this subsection for any month is the product of—

(1) $195, multiplied by

(2) the number of persons who were partners in the partnership during any part of the taxable year.

(c) Assessment of penalty

The penalty imposed by subsection (a) shall be assessed against the partnership.

(d) Deficiency procedures not to apply

Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply in respect of the assessment or collection of any penalty imposed by subsection (a).

(e) Adjustment for inflation

(1) In general

In the case of any return required to be filed in a calendar year beginning after 2014, the $195 dollar amount under subsection (b)(1) shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for the calendar year determined by substituting "calendar year 2013" for "calendar year 2016" in subparagraph (A)(ii) thereof.

(2) Rounding

If any amount adjusted under paragraph (1) is not a multiple of $5, such amount shall be rounded to the next lowest multiple of $5.

§ 7701. Definitions

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) Person

The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(2) Partnership and partner

The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) Corporation

The term "corporation" includes associations, joint-stock companies, and insurance companies.

(4) Domestic

The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.

(5) Foreign

The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) Fiduciary

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) Stock

The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) Shareholder

The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

(9) United States

The term "United States" when used in a geographical sense includes only the States and the District of Columbia.

(10) State

The term "State" shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.

(11) Secretary of the Treasury and Secretary

(A) Secretary of the Treasury

The term “Secretary of the Treasury” means the Secretary of the Treasury, personally, and shall not include any delegate of his.

(B) Secretary

The term “Secretary” means the Secretary of the Treasury or his delegate.

(12) Delegate

(A) In general

The term “or his delegate”—

(i) when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context; and

(ii) when used with reference to any other official of the United States, shall be similarly construed.

(B) Performance of certain functions in Guam or American Samoa

The term “delegate,” in relation to the performance of functions in Guam or American Samoa with respect to the taxes imposed by chapters 1, 2, and 21, also includes any officer or employee of any other department or agency of the United States, or of any possession thereof, duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform such functions.

(13) Commissioner

The term “Commissioner” means the Commissioner of Internal Revenue.

(14) Taxpayer

The term “taxpayer” means any person subject to any internal revenue tax.

(15) Military or naval forces and armed forces of the United States

The term “military or naval forces of the United States” and the term “Armed Forces of the United States” each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each term also includes the Coast Guard. The members of such forces include commissioned officers and personnel below the grade of commissioned officers in such forces.

(16) Withholding agent

The term “withholding agent” means any person required to deduct and withhold any tax under the provisions of section 1441, 1442, 1443, or 1461.

(17) Husband and wife

As used in section 2516, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such section, the term “wife” shall be read “former wife” and the term “husband” shall be read “former husband”; and, if the payments described in such section are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such section, the term “husband” shall be read “wife” and the term “wife” shall be read “husband.”

(18) International organization

The term “international organization” means a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288–288f).

(19) Domestic building and loan association

The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary,

(x) property used by the association in the conduct of the business described in subparagraph (B), and

(xi) any regular or residual interest in a REMIC, but only in the proportion which the assets of such REMIC consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC are assets described in clauses (i) through (x), the entire interest in the REMIC shall qualify.

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property. For purposes of determining whether any interest in a REMIC qualifies under clause (xi), any regular interest in another REMIC held by such REMIC shall be treated as a loan described in a preceding clause under principles similar to the principles of clause (xi); except that, if such REMIC's are part of a tiered structure, they shall be treated as 1 REMIC for purposes of clause (xi).

(20) Employee

For the purpose of applying the provisions of section 79 with respect to group-term life insurance purchased for employees, for the purpose of applying the provisions of sections 104, 105, and 106 with respect to accident and health insurance or accident and health plans, and for the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, and for purposes of applying section 125 with respect to cafeteria plans, the term "employee" shall include a full-time life insurance salesman who is considered an employee for the purpose of chapter 21.

(21) Levy

The term "levy" includes the power of distraint and seizure by any means.

(22) Attorney General

The term "Attorney General" means the Attorney General of the United States.

(23) Taxable year

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the

Secretary, the period for which such return is made.

(24) Fiscal year

The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December.

(25) Paid or incurred, paid or accrued

The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A.

(26) Trade or business

The term "trade or business" includes the performance of the functions of a public office.

(27) Tax Court

The term "Tax Court" means the United States Tax Court.

(28) Other terms

Any term used in this subtitle with respect to the application of, or in connection with, the provisions of any other subtitle of this title shall have the same meaning as in such provisions.

(29) Internal Revenue Code

The term "Internal Revenue Code of 1986" means this title, and the term "Internal Revenue Code of 1939" means the Internal Revenue Code enacted February 10, 1939, as amended.

(30) United States person

The term "United States person" means—

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation,

(D) any estate (other than a foreign estate, within the meaning of paragraph (31)), and

(E) any trust if—

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.

(31) Foreign estate or trust

(A) Foreign estate

The term "foreign estate" means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.

(B) Foreign trust

The term "foreign trust" means any trust other than a trust described in subparagraph (E) of paragraph (30).

(32) Cooperative bank

The term "cooperative bank" means an institution without capital stock organized and operated for mutual purposes and without profit, which—

(A) is subject by law to supervision and examination by State or Federal authority having supervision over such institutions, and

(B) meets the requirements of subparagraphs (B) and (C) of paragraph (19) of this subsection (relating to definition of domestic building and loan association).

In determining whether an institution meets the requirements referred to in subparagraph (B) of this paragraph, any reference to an association or to a domestic building and loan association contained in paragraph (19) shall be deemed to be a reference to such institution.

(33) Regulated public utility

The term “regulated public utility” means—

(A) A corporation engaged in the furnishing or sale of—

(i) electric energy, gas, water, or sewerage disposal services, or

(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) transportation (not included in clause (ii)) by motor vehicle—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission.

(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Surface Transportation Board, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Secretary of Transportation.

(F) A corporation engaged in the furnishing or sale of transportation by a water carrier subject to jurisdiction under subchapter II of chapter 135 of title 49.

(G) A rail carrier subject to part A of subtitle IV of title 49, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into before January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, an agreement for lease of railroad properties entered into before January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into before January 1, 1954.

(H) A common parent corporation which is a common carrier by railroad subject to part A of subtitle IV of title 49 if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (G), received from a regulated public utility shall be considered as derived from sources described in subparagraphs (A) through (F), inclusive, if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

The term "regulated public utility" does not (except as provided in subparagraphs (G) and (H)) include a corporation described in subparagraphs (A) through (F), inclusive, unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in subparagraphs (A) through (F), inclusive. If the taxpayer establishes to the satisfaction of the Secretary that (i) its revenue from regulated rates described in subparagraph (A) or (D) and its revenue derived from unregulated rates are derived from the operation of a single interconnected and coordinated system or from the operation of more than one such system, and (ii) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, then such revenue from such unregulated rates shall be considered, for purposes of the preceding sentence, as income derived from sources described in subparagraph (A) or (D).

[(34) Repealed. Pub. L. 98–369, div. A, title IV, § 4112(b)(11), July 18, 1984, 98 Stat. 792]

(35) Enrolled actuary

The term "enrolled actuary" means a person who is enrolled by the Joint Board for the Enrollment of Actuaries established under subtitle C of the title III of the Employee Retirement Income Security Act of 1974.

(36) Tax return preparer

(A) In general

The term "tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

(B) Exceptions

A person shall not be a "tax return preparer" merely because such person—

(i) furnishes typing, reproducing, or other mechanical assistance,

(ii) prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,

(iii) prepares as a fiduciary a return or claim for refund for any person, or

(iv) prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

(37) Individual retirement plan

The term "individual retirement plan" means—

(A) an individual retirement account described in section 408(a), and

(B) an individual retirement annuity described in section 408(b).

(38) Joint return

The term "joint return" means a single return made jointly under section 6013 by a husband and wife.

(39) Persons residing outside United States

If any citizen or resident of the United States does not reside in (and is not found in) any United States judicial district, such citizen or resident shall be treated as residing in the District of Columbia for purposes of any provision of this title relating to—

(A) jurisdiction of courts, or

(B) enforcement of summons.

(40) Indian tribal government

(A) In general

The term "Indian tribal government" means the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary, after consultation with the Secretary of the Interior, to exercise governmental functions.

(B) Special rule for Alaska Natives

No determination under subparagraph (A) with respect to Alaska Natives shall grant or defer any status or powers other than those enumerated in section 7871. Nothing in the Indian Tribal Governmental Tax Status Act of 1982, or in the amendments made thereby, shall validate or invalidate any claim by Alaska Natives of sovereign authority over lands or people.

(41) TIN

The term "TIN" means the identifying number assigned to a person under section 6109.

(42) Substituted basis property

The term "substituted basis property" means property which is—

(A) transferred basis property, or

(B) exchanged basis property.

(43) Transferred basis property

The term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

(44) Exchanged basis property

The term "exchanged basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

(45) Nonrecognition transaction

The term "nonrecognition transaction" means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

(46) Determination of whether there is a collective bargaining agreement

In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term "employee representatives" shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer. An agreement shall not be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and 1 or more employers.

[(47) Repealed. Pub. L. 111–312, title III, § 301(a), Dec. 17, 2010, 124 Stat. 3300]

(48) Off-highway vehicles

(A) Off-highway transportation vehicles

(i) In general

A vehicle shall not be treated as a highway vehicle if such vehicle is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design such vehicle's capability to transport a load over the public highway is substantially limited or impaired.

(ii) Determination of vehicle's design

For purposes of clause (i), a vehicle's design is determined solely on the basis of its physical characteristics.

(iii) Determination of substantial limitation or impairment

For purposes of clause (i), in determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether such vehicle is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether such vehicle can transport a load at a sustained speed of at least 25 miles per hour. It is immaterial that a vehicle can transport a greater load off the public highway than such vehicle is permitted to transport over the public highway.

(B) Nontransportation trailers and semitrailers

A trailer or semitrailer shall not be treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an off-highway function at an off-highway site.

(49) Qualified blood collector organization

The term “qualified blood collector organization” means an organization which is—

(A) described in section 501(c)(3) and exempt from tax under section 501(a),

(B) primarily engaged in the activity of the collection of human blood,

(C) registered with the Secretary for purposes of excise tax exemptions, and

(D) registered by the Food and Drug Administration to collect blood.

(50) Termination of United States citizenship

(A) In general

An individual shall not cease to be treated as a United States citizen before the date on which the individual’s citizenship is treated as relinquished under section 877A(g)(4).

(B) Dual citizens

Under regulations prescribed by the Secretary, subparagraph (A) shall not apply to an individual who became at birth a citizen of the United States and a citizen of another country.

Code of Federal Regulations
Title 26
Selected Sections

§ 1.1(h)-1 Capital gains look-through rule for sales or exchanges of interests in a partnership, S corporation, or trust.

(a) *In general.* When an interest in a partnership held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under section 751(a)), collectibles gain, section 1250 capital gain, and residual long-term capital gain or loss. When stock in an S corporation held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under sections 304, 306, 341, 1254), collectibles gain, and residual long-term capital gain or loss. When an interest in a trust held for more than one year is sold or exchanged, a transferor who is not treated as the owner of the portion of the trust attributable to the interest sold or exchanged (sections 673 through 679) (a non-grantor transferor) may recognize collectibles gain and residual long-term capital gain or loss.

(b) *Look-through capital gain* -

(1) *In general.* Look-through capital gain is the share of collectibles gain allocable to an interest in a partnership, S corporation, or trust, plus the share of section 1250 capital gain allocable to an interest in a partnership, determined under paragraphs (b)(2) and (3) of this section.

(2) *Collectibles gain* -

(i) *Definition.* For purposes of this section, *collectibles gain* shall be treated as gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to section 408(m)(3)) that is a capital asset held for more than 1 year.

(ii) *Share of collectibles gain allocable to an interest in a partnership, S corporation, or a trust.* When an interest in a partnership, S corporation, or trust held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net gain (but not net loss) that would be allocated to that partner (taking into account any remedial allocation under § 1.704-3(d)), shareholder, or beneficiary (to the extent attributable to the portion of the partnership interest, S corporation stock, or trust interest transferred that was held for more than one year) if the partnership, S corporation, or trust transferred all of its collectibles for cash equal to the fair market value of the assets in a fully taxable transaction immediately before the transfer of the interest in the partnership, S corporation, or trust. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, S corporation, or trust, the same methodology shall apply to determine the collectibles gain recognized by the transferor, except that the partnership, S corporation, or trust shall be treated as transferring only a proportionate amount of each of its collectibles determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. With respect to the transfer of an interest in a trust, this paragraph (b)(2) applies only to transfers by non-grantor transferors (as defined in paragraph (a) of this section). This paragraph (b)(2) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of an interest in a partnership, S corporation, or trust.

(3) *Section 1250 capital gain* -

(i) *Definition.* For purposes of this section, *section 1250 capital gain* means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent.

(ii) *Share of section 1250 capital gain allocable to interest in partnership.* When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated (taking into account any remedial allocation under § 1.704-3(d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its section 1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the section 1250 capital gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each section 1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. This paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest.

(iii) *Limitation with respect to net section 1231 gain.* In determining a transferor partner's net section 1231 gain (as defined in section 1231(c)(3)) for purposes of section 1(h)(7)(B), the transferor partner's allocable share of section 1250 capital gain in partnership property shall not be treated as section 1231 gain, regardless of whether the partnership property is used in the trade or business (as defined in section 1231(b)).

(c) *Residual long-term capital gain or loss.* The amount of residual long-term capital gain or loss recognized by a partner, shareholder of an S corporation, or beneficiary of a trust on account of the sale or exchange of an interest in a partnership, S corporation, or trust shall equal the amount of long-term capital gain or loss that the partner would recognize under section 741, that the shareholder would recognize upon the sale or exchange of stock of an S corporation, or that the beneficiary would recognize upon the sale or exchange of an interest in a trust (pre-look-through long-term capital gain or loss) minus the amount of look-through capital gain determined under paragraph (b) of this section.

(d) *Special rule for tiered entities.* In determining whether a partnership, S corporation, or trust has gain from collectibles, such partnership, S corporation, or trust shall be treated as owning its proportionate share of the collectibles of any partnership, S corporation, or trust in which it owns an interest either directly or indirectly through a chain of such entities. In determining whether a partnership has section 1250 capital gain, such partnership shall be treated as owning its proportionate share of the section 1250 property of any partnership in which it owns an interest, either directly or indirectly through a chain of partnerships.

(e) *Notification requirements.* Reporting rules similar to those that apply to the partners and the partnership under section 751(a) shall apply in the case of sales or exchanges of interests in a partnership, S corporation, or trust that cause holders of such interests to recognize collectibles gain and in the case of sales or exchanges of interests in a partnership that cause holders of such interests to recognize section 1250 capital gain. See § 1.751-1(a)(3).

(f) *Examples.* The following examples illustrate the requirements of this section:

Example 1. Collectibles gain.

(i) *A* and *B* are equal partners in a personal service partnership (*PRS*). *B* transfers *B*'s 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:

ASSETS

	Adjusted basis	**Market value**
Cash	$3,000	$3,000
Loans Owed to Partnership	10,000	10,000
Collectibles	1,000	3,000
Other Capital Assets	6,000	2,000

ASSETS

	Adjusted basis	Market value
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

LIABILITIES AND CAPITAL

	Adjusted basis	Market value
Liabilities	2,000	2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

(ii) At the time of the transfer, *B* has held the interest in *PRS* for more than one year, and *B*'s basis for the partnership interest is $10,000 ($9,000 plus $1,000, *B*'s share of partnership liabilities). None of the property owned by *PRS* is section 704(c) property. 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 one-half interest in *PRS* includes a one-half interest in the partnership's unrealized receivables and a one-half interest in the partnership's collectibles.

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B's* partnership interest to *T, B* would be 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 § 1.751-1(a)(2) ($7,000) is the partner's capital gain or loss on the sale of the partnership interest under section 741. In this case, the transferor has a $1,000 pre-look-through long-term capital loss.

(iv) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B's* partnership interest to *T, B* would be allocated $1,000 of gain from the sale of the collectibles. Therefore, *B* will recognize $1,000 of collectibles gain on account of the collectibles held by *PRS.*

(v) The difference between the transferor's pre-look-through long-term capital gain or loss (−$1,000) and the look-through capital gain determined under this section ($1,000) is the transferor's residual long-term capital gain or loss on the sale of the partnership interest. Under these facts, *B* will recognize a $2,000 residual long-term capital loss on account of the sale or exchange of the interest in *PRS.*

Example 2. Special allocations.

Assume the same facts as in *Example 1,* except that under the partnership agreement, all gain from the sale of the collectibles is specially allocated to *B,* and *B* transfers *B*'s interest to *T* for $16,000. All items of income, gain, loss, or deduction of *PRS,* other than the gain from the collectibles, are divided equally between *A* and *B*. Under these facts, *B*'s amount realized is $17,000, consisting of the cash received, $16,000, plus $1,000, *B's* share of the partnership liabilities assumed by *T.* See section 752. *B* will recognize $7,000 of ordinary income with respect to the unrealized receivables (determined under § 1.751-1(a)(2)). Accordingly, *B*'s pre-look-through long-term capital gain would be $0. If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B's* partnership interest to *T, B* would be allocated $2,000 of gain from the sale of the collectibles. Therefore, *B* will recognize $2,000 of collectibles gain on account of the collectibles held by *PRS. B* will recognize a $2,000 residual long-term capital loss on account of the sale of *B's* interest in *PRS.*

Example 3. Net collectibles loss ignored.

Assume the same facts as in *Example 1,* except that the collectibles held by *PRS* have an adjusted basis of $3,000 and a fair market value of $1,000, and the other capital assets have an adjusted basis of $4,000 and a fair market value of $4,000. (The total adjusted basis and fair market value of the partnership's capital assets are the same as in *Example 1.*) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T, B* would be allocated $1,000 of loss from the sale of the collectibles. Because none of the gain from the sale of the interest in *PRS* is attributable to unrealized appreciation in the value of collectibles held by *PRS,* the net loss in collectibles held by *PRS* is not recognized at the time *B* transfers the interest in *PRS. B* will recognize $7,000 of ordinary income (determined under § 1.751-1(a)(2)) and a $1,000 long-term capital loss on account of the sale of B's interest in *PRS.*

Example 4. Collectibles gain in an S corporation.

(i) A corporation (*X*) has always been an S corporation and is owned by individuals *A, B,* and *C.* In 1996, *X* invested in antiques. Subsequent to their purchase, the antiques appreciated in value by $300. *A* owns one-third of the shares of *X* stock and has held that stock for more than one year. *A*'s adjusted basis in the *X* stock is $100. If *A* were to sell all of *A*'s *X* stock to *T* for $150, *A* would realize $50 of pre-look-through long-term capital gain.

(ii) If *X* were to sell its antiques in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer to *T, A* would be allocated $100 of gain on account of the sale. Therefore, *A* will recognize $100 of collectibles gain (look-through capital gain) on account of the collectibles held by *X.*

(iii) The difference between the transferor's pre-look-through long-term capital gain or loss ($50) and the look-through capital gain determined under this section ($100) is the transferor's residual long-term capital gain or loss on the sale of the S corporation stock. Under these facts, *A* will recognize $100 of collectibles gain and a $50 residual long-term capital loss on account of the sale of *A*'s interest in *X.*

Example 5. Sale or exchange of partnership interest where part of the interest has a short-term holding period.

(i) *A, B,* and *C* form an equal partnership (*PRS*). In connection with the formation, *A* contributes $5,000 in cash and a capital asset with a fair market value of $5,000 and a basis of $2,000; *B* contributes $7,000 in cash and a collectible with a fair market value of $3,000 and a basis of $3,000; and *C* contributes $10,000 in cash. At the time of the contribution, *A* had held the contributed property for two years. Six months later, when *A*'s basis in *PRS* is $7,000, *A* transfers *A*'s interest in *PRS* to *T* for $14,000 at a time when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS

	Adjusted basis	**Market value**
Cash	$22,000	$22,000
Unrealized Receivables	0	6,000
Capital Asset	2,000	5,000
Collectible	3,000	9,000
Capital Assets	5,000	14,000

ASSETS		
	Adjusted basis	**Market value**
Total	27,000	42,000

(ii) Although at the time of the transfer *A* has not held *A*'s interest in *PRS* for more than one year, 50 percent of the fair market value of *A*'s interest in *PRS* was received in exchange for a capital asset with a long-term holding period. Therefore, 50 percent of *A*'s interest in *PRS* has a long-term holding period. See § 1.1223-3(b)(1).

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $2,000 of ordinary income. Accordingly, *A* will recognize $2,000 ordinary income and $5,000 ($7,000-$2,000) of capital gain on account of the transfer to *T* of *A*'s interest in *PRS.* Fifty percent ($2,500) of that gain is long-term capital gain and 50 percent ($2,500) is short-term capital gain. See § 1.1223-3(c)(1).

(iv) If the collectible were sold or exchanged in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $2,000 of gain attributable to the collectible. The gain attributable to the collectible that is allocable to the portion of the transferred interest in *PRS* with a long-term holding period is $1,000 (50 percent of $2,000). Accordingly, *A* will recognize $1,000 of collectibles gain on account of the transfer of *A*'s interest in *PRS.*

(v) The difference between the amount of pre-look-through long-term capital gain or loss ($2,500) and the look-through capital gain ($1,000) is the amount of residual long-term capital gain or loss that *A* will recognize on account of the transfer of *A*'s interest in *PRS.* Under these facts, *A* will recognize a residual long-term capital gain of $1,500 and a short-term capital gain of $2,500.

(g) *Effective date.* This section applies to transfers of interests in partnerships, S corporations, and trusts that occur on or after September 21, 2000.

[T.D. 8902, 65 FR 57096, Sept. 21, 2000]

§ 1.83-1 Property transferred in connection with the performance of services.

(a) *Inclusion in gross income* -

(1) *General rule.* Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred (as defined in § 1.83-3(a)) to such person and become substantially vested (as defined in § 1.83-3(b)) in such person. In that case, the excess of -

(i) The fair market value of such property (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) at the time that the property becomes substantially vested, over

(ii) The amount (if any) paid for such property,

shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested. Until such property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available. This paragraph applies to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed.

(2) *Life insurance.* The cost of life insurance protection under a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is taxable generally under section 61 and the regulations thereunder during the period such contract remains substantially nonvested (as defined in § 1.83-3(b)). For the taxation of life insurance protection under a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)), see § 1.61-22.

(3) *Cross references.* For rules concerning the treatment of employers and other transferors of property in connection with the performance of services, see section 83(h) and § 1.83-6. For rules concerning the taxation of beneficiaries of an employees' trust that is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

§ 1.83-6 Deduction by employer.

(b) *Recognition of gain or loss.* Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between

(1) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and

(2) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

§ 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 § 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, §§ 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

(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.

§ 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 § 1.706-1(a). Such distributive share shall be determined as provided in section 704 and § 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. Each partner subject to section 1061 must take into account gains and losses from sales of capital assets held for more than one year as provided in section 1061 and §§ 1.1061-1 through 1.1061-6.

(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 the partner's 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, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if separately taken into account by the controlled foreign corporation 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 gross income the part of the partner's 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 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. This paragraph (a)(8)(ii) applies to taxable years beginning on or after July 23, 2002.

(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 § 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.

§ 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 § 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 § 1.702-1.

(v) The net operating loss deduction provided in section 172. See § 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 § 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 § 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.

§ 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* - (0) *Cross-references.*

Table 1 to Paragraph (b)(0)

Heading	Section
Cross-references	1.704-1(b)(0)
In general	1.704-1(b)(1)
Basic principles	1.704-1(b)(1)(i)
Effective dates	1.704-1(b)(1)(ii)
Generally	1.704-1(b)(1)(ii)(*a*)
Foreign tax expenditures	1.704-1(b)(1)(ii)(*b*)
In general	1.704-1(b)(1)(ii)(*b*)(*1*)
Special rules for certain interbranch payments	1.704-1(b)(1)(ii)(*b*)(*3*)
Effect of other sections	1.704-1(b)(1)(iii)
Other possible tax consequences	1.704-1(b)(1)(iv)
Purported allocations	1.704-1(b)(1)(v)
Section 704(c) determinations	1.704-1(b)(1)(vi)
Bottom line allocations	1.704-1(b)(1)(vii)
Substantial economic effect	1.704-1(b)(2)
Two-part analysis	1.704-1(b)(2)(i)
Economic effect	1.704-1(b)(2)(ii)
Fundamental principles	1.704-1(b)(2)(ii)(*a*)
Three requirements	1.704-1(b)(2)(ii)(*b*)
Obligation to restore deficit	1.704-1(b)(2)(ii)(*c*)
Alternate test for economic effect	1.704-1(b)(2)(ii)(*d*)
Partial economic effect	1.704-1(b)(2)(ii)(*e*)
Reduction of obligation to restore	1.704-1(b)(2)(ii)(*f*)
Liquidation defined	1.704-1(b)(2)(ii)(*g*)
Partnership agreement defined	1.704-1(b)(2)(ii)(*h*)
Economic effect equivalence	1.704-1(b)(2)(ii)(*i*)
Substantiality	1.704-1(b)(2)(iii)
General rules	1.704-1(b)(2)(iii)(*a*)
Shifting tax consequences	1.704-1(b)(2)(iii)(*b*)
Transitory allocations	1.704-1(b)(2)(iii)(*c*)
Maintenance of capital accounts	1.704-1(b)(2)(iv)
In general	1.704-1(b)(2)(iv)(*a*)
Basic rules	1.704-1(b)(2)(iv)(*b*)
Treatment of liabilities	1.704-1(b)(2)(iv)(*c*)
Contributed property	1.704-1(b)(2)(iv)(*d*)
In general	1.704-1(b)(2)(iv)(*d*)(*1*)
Contribution of promissory notes	1.704-1(b)(2)(iv)(*d*)(*2*)
Section 704(c) considerations	1.704-1(b)(2)(*iv*)(*d*)(*3*)
Exercise of noncompensatory options	1.704-1(b)(2)(iv)(*d*)(*4*).
Distributed property	1.704-1(b)(2)(iv)(*e*)
In general	1.704-1(b)(2)(iv)(*e*)(*1*)
Distribution of promissory notes	1.704-1(b)(2)(iv)(*e*)(*2*)
Revaluations of property	1.704-1(b)(2)(iv)(*f*)
Adjustments to reflect book value	1.704-1(b)(2)(iv)(*g*)

Heading	Section
In general	1.704-1(b)(2)(iv)(*g*)(*1*)
Payables and receivables	1.704-1(b)(2)(iv)(*g*)(*2*)
Determining amount of book items	1.704-1(b)(2)(iv)(*g*)(*3*)
Determinations of fair market value	1.704-1(b)(2)(iv)(*h*)
In general	1.704-1(b)(2)(iv)(*h*)(*1*).
Adjustments for noncompensatory options	1.704-1(b)(2)(iv)(*h*)(*2*).
Section 705(a)(2)(B) expenditures	1.704-1(b)(2)(iv)(*i*)
In general	1.704-1(b)(2)(iv)(*i*)(*1*)
Expenses described in section 709	1.704-1(b)(2)(iv)(*i*)(*2*)
Disallowed losses	1.704-1(b)(2)(iv)(*i*)(*3*)
Basis adjustments to section 38 property	1.704-1(b)(2)(iv)(*j*)
Depletion of oil and gas properties	1.704-1(b)(2)(iv)(*k*)
In general	1.704-1(b)(2)(iv)(*k*)(*1*)
Simulated depletion	1.704-1(b)(2)(iv)(*k*)(*2*)
Actual depletion	1.704-1(b)(2)(iv)(*k*)(*3*)
Effect of book values	1.704-1(b)(2)(iv)(*k*)(*4*)
Transfers of partnership interests	1.704-1(b)(2)(iv)(l)
Section 754 elections	1.704-1(b)(2)(iv)(m)
In general	1.704-1(b)(2)(iv)(*m*)(*1*)
Section 743 adjustments	1.704-1(b)(2)(iv)(*m*)(*2*)
Section 732 adjustments	1.704-1(b)(2)(iv)(*m*)(*3*)
Section 734 adjustments	1.704-1(b)(2) iv)(*m*)(*4*)
Limitations on adjustments	1.704-1(b)(2) iv)(*m*)(*5*)
Partnership level characterization	1.704-1(b)(2)(iv)(*n*)
Guaranteed payments	1.704-1(b)(2)(iv)(*o*)
Minor discrepancies	1.704-1(b)(2)(iv)(*p*)
Adjustments where guidance is lacking	1.704-1(b)(2)(iv)(*q*)
Restatement of capital accounts	1.704-1(b)(2)(iv)(*r*)
Adjustments on the exercise of a noncompensatory option	1.704-1(b)(2)(iv)(*s*).
Partner's interest in the partnership	1.704-1(b)(3)
In general	1.704-1(b)(3)(i)
Factors considered	1.704-1(b)(3)(ii)
Certain determinations	1.704-1(b)(3)(iii)
Special rules	1.704-1(b)(4)
Allocations to reflect revaluations	1.704-1(b)(4)(i)
Credits	1.704-1(b)(4)(ii)
Excess percentage depletion	1.704-1(b)(4)(iii)
Allocations attributable to nonrecourse liabilities	1.704-1(b)(4)(iv)
Allocations under section 613A(c(7)(D)	1.704-1(b)(4)(v)
Amendments to partnership agreement	1.704-1(b)(4)(vi)
Recapture	1.704-1(b)(4)(vii)
Allocation of creditable foreign taxes	1.704-1(b)(4)(viii)
In general	1.704-1(b)(4)(viii)(*a*)

(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 § 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/applicability date.*

(*a*) *Generally.* Except as otherwise provided in this section, 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. Paragraphs (b)(2)(iii)(*a*) (last sentence), (b)(2)(iii)(*d*), (b)(2)(iii)(*e*), and (b)(5) *Example 28*, *Example 29*, and *Example 30* of this section apply to partnership taxable years beginning on or after May 19, 2008. In addition, paragraph (b)(2)(iv)(*d*)(*4*), paragraph (b)(2)(iv)(*f*)(*1*), paragraph (b)(2)(iv)(*f*)(*5*)(*iv*), paragraph (b)(2)(iv)(*h*)(*2*), paragraph (b)(2)(iv)(*s*), paragraph (b)(4)(ix), paragraph (b)(4)(x), and *Examples 31* through *35* in paragraph (b)(5) of this section apply to noncompensatory options (as defined in § 1.721-2(f)) that are issued on or after February 5, 2013. The last sentence of paragraph (b)(2)(iv)(*g*)(*3*) of this section is applicable for partnership taxable years ending on or after September 24, 2019. However, a partnership may choose to apply the last sentence in paragraph (b)(2)(iv)(*g*)(*3*) of this section for the partnership's taxable years ending on or after September 28, 2017. A partnership may rely on the last sentence in paragraph (b)(2)(iv)(g)(3) of this section in regulation project REG-104397-18 (2018-41 I.R.B. 558) (see § 601.601(d)(2)(ii)(b) of this chapter) for the partnership's taxable years ending on or after September 28, 2017, and ending before the partnership's taxable year that includes September 24, 2019. Furthermore, the last sentence of paragraph (b)(2)(ii)(*b*)(*3*) of this section and paragraphs (b)(2)(ii)(*b*)(*4*) through (*7*) and (b)(2)(ii)(*c*) of this section apply to partnership taxable years ending on or after *October 9, 2019*. However, taxpayers may apply the last sentence of paragraph (b)(2)(ii)(*b*)(*3*) of this section and paragraphs (b)(2)(ii)(*b*)(*4*) through (*7*) and (b)(2)(ii)(*c*) of this section for partnership taxable years ending on or after October 5, 2016. For partnership taxable years ending before October 9, 2019, see § 1.704-1 as contained in 26 CFR part 1 revised as of April 1, 2019.

(*b*) *Rules relating to foreign tax expenditures.*

(*1*) *In general.* Except as otherwise provided in this paragraph (b)(1)(ii)(*b*)(*1*), the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section (regarding the allocation of creditable foreign taxes) apply for partnership taxable years beginning on or after October 19, 2006. The rules that apply to allocations of creditable foreign taxes made in partnership taxable years beginning before October 19, 2006 are contained in § 1.704-1T(b)(1)(ii)(*b*)(*1*) and (b)(4)(xi) as in effect before October 19, 2006 (see 26 CFR part 1 revised as of April 1, 2005). However, taxpayers may rely on the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004. Except as provided in the next sentence, the provisions of paragraphs (b)(4)(viii)(*a*)(*1*), (b)(4)(viii)(*c*)(*1*), (b)(4)(viii)(*c*)(*2*)(*ii*) and (*iii*), (b)(4)(viii)(*c*)(*3*) and (*4*), and (b)(4)(viii)(*d*)(*1*) (as in effect on July 24, 2019) and in paragraphs (b)(6)(i), (ii), and (iii) of this section (*Examples 1, 2,* and *3*) apply for partnership taxable years that both begin on or after January 1, 2016, and end after February 4, 2016. For partnership taxable years beginning after December 31, 2019, paragraph (b)(4)(viii)(*d*)(*1*) of this section applies. For the rules that apply to partnership taxable years beginning on or after October 19, 2006, and before January 1, 2016, and to taxable years that both begin on or after January 1, 2016, and end on or before February 4, 2016, see § 1.704-1(b)(1)(ii)(*b*), (b)(4)(viii)(*a*)(*1*), (b)(4)(viii)(*c*)(*1*), (b)(4)(viii)(*c*)(*2*)(*ii*) and (*iii*), (b)(4)(viii)(*c*)(*3*) and (*4*), (b)(4)(viii)(*d*)(*1*), and (b)(5), *Example 25* (as contained in 26 CFR part 1 revised as of April 1, 2015).

(*2*) *Transition rule.* Transition relief is provided herein to partnerships whose agreements were entered into prior to April 21, 2004. In such case, if there has been no material modification to the partnership agreement on or after April 21, 2004, then the partnership may apply the provisions of paragraph (b) of this section as if the amendments made by paragraphs (b)(3)(iv) and (b)(4)(viii) of this section had not occurred. If the partnership agreement was materially modified on or after April 21, 2004, then the rules provided in paragraphs (b)(3)(iv) and (b)(4)(viii) of this section shall apply to the later of the taxable year beginning on or after October 19, 2006 or the taxable year within which the material modification occurred, and to all subsequent taxable years. If the partnership agreement was materially modified on or after April 21, 2004, and before a tax year beginning on or after October 19, 2006, see §§ 1.704-1T(b)(1)(ii)(*b*)(*1*) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (26 CFR part 1 revised as of April 1, 2005). For purposes of this paragraph (b)(1)(ii)(*b*)(*2*), any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year (and all subsequent taxable years) in which persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

(*3*) *Special rules for certain inter-branch payments* -

(i) *In general.* The provisions of § 1.704-1(b)(4)(viii)(*d*)(*3*) apply for partnership taxable years ending after February 9, 2015. See 26 CFR 1.704-1T(b)(4)(viii)(*d*)(*3*) (revised as of April 1, 2014) for rules applicable to taxable years beginning on or after January 1, 2012, and ending on or before February 9, 2015.

(*ii*) *Transition rule.* Transition relief is provided by this paragraph (b)(1)(ii)(*b*)(*3*)(*ii*) to partnerships whose agreements were entered into before February 14, 2012. In such cases, if there has been no material modification to the partnership agreement on or after February 14, 2012, then, for taxable years beginning on or after January 1, 2012, and before January 1, 2016, and for taxable years that both begin on or after January 1, 2012, and end on or before February 4, 2016, these partnerships may apply the provisions of § 1.704-1(b)(4)(viii)(*c*)(*3*)(*ii*) and (b)(4)(viii)(*d*)(*3*) (see 26 CFR part 1 revised as of April 1, 2011). For taxable years that both begin on or after January 1, 2016, and end after February 4, 2016, these partnerships may apply the provisions of § 1.704-1(b)(4)(viii)(*d*)(*3*) (see 26 CFR part 1 revised as of April 1, 2011). For purposes of this paragraph (b)(1)(ii)(*b*)(*3*), any change in ownership constitutes a material modification to the partnership agreement. The transition rule in this paragraph (b)(1)(ii)(*b*)(*3*)(*ii*) does not apply to any taxable year in which persons bearing a relationship to each other that is specified in section 267(b) or section 707(b) collectively have the power to amend the partnership agreement without the consent of any unrelated party (and all subsequent taxable years).

(*4*) *Special rules for covered asset acquisitions.* Paragraphs (b)(4)(viii)(*c*)(*4*)(*v*) through (*vii*) of this section apply to covered asset acquisitions (CAAs) (as defined in § 1.901(m)-1(a)(13)) occurring on or after March 23, 2020. Taxpayers may, however, choose to apply paragraphs (b)(4)(viii)(*c*)(*4*)(*v*) through (*vii*) of this section before the date paragraphs (b)(4)(viii)(*c*)(*4*)(*v*) through (*vii*) of this section are applicable provided that they (along with any persons that are related (within the meaning of section 267(b) or 707(b)) to the taxpayer) -

(*i*) Consistently apply paragraphs (b)(4)(viii)(*c*)(*4*)(*v*) through (*vii*) of this section, § 1.901(m)-1, and §§ 1.901(m)-3 through 1.901(m)-8 (excluding § 1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016, on any original or amended tax return for each taxable year for which the application of the provisions listed in this paragraph (b)(1)(ii)(*b*)(*4*)(*i*) affects the tax liability and for which the statute of limitations does not preclude assessment or the filing of a claim for refund, as applicable;

(*ii*) File all tax returns described in paragraph (b)(1)(ii)(*b*)(*4*)(*i*) of this section for any taxable year ending on or before March 23, 2020, no later than March 23, 2021; and

(*iii*) Make appropriate adjustments to take into account deficiencies that would have resulted from the consistent application under paragraph (b)(1)(ii)(*b*)(*4*)(*i*) of this section for taxable years that are not open for assessment.

(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 § 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 § 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 § 1.46-3, § 1.47-6, paragraph (b)(1) of § 1.721-1 (and related principles), and paragraph (e) of § 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 § 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 § 1.707-1).

(vi) Section 704(c) determinations. Section 704(c) and § 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 § 1.704-3 (depending on the allocation method chosen by the partnership under § 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 § 1.704-3 for methods of making allocations under section 704(c), and § 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*)). Notwithstanding the partnership agreement, an obligation to restore a deficit balance in a partner's capital account, including an obligation described in paragraph (b)(2)(ii)(*c*)(*1*) of this section, will not be respected for purposes of this section to the extent the obligation is disregarded under paragraph (b)(2)(ii)(*c*)(*4*) of this section.

(*4*) For purposes of paragraphs (b)(2)(ii)(*b*)(*1*) through (*3*) of this section, a partnership taxable year shall be determined without regard to section 706(c)(2)(A).

(*5*) The requirements in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section 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.

(*6*) The requirement in paragraph (b)(2)(ii)(*b*)(*2*) of this section 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 the requirement in paragraph (b)(2)(ii)(*b*)(*2*) of this section 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.

(*7*) See *Examples 1.*(i) and *(ii), 4.(i), 8.(i),* and *16.(i)* of paragraph (b)(5) of this section for issues concerning paragraph (b)(2)(ii)(*b*) of this section.

(*c*) *Obligation to restore deficit* -

(*1*) *Other arrangements treated as obligations to restore deficits* . If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with the requirement in paragraph (b)(2)(ii)(*b*)(*3*) of this section and subject to paragraph (b)(2)(ii)(*c*)(*2*) of this section) to the extent of -

(*A*) 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

(*B*) 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).

(*2*) Satisfaction requirement. For purposes of paragraph (b)(2)(ii)(*c*)(*1*) of this section, a promissory note or unconditional obligation is taken into account only if it 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 paragraph (b)(2)(ii)(*c*)(*1*) of this section is negotiable, a partner will be considered required to satisfy such note within the time period specified in this paragraph (b)(2)(ii)(*c*)(*2*) 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.

(*3*) *Related party notes.* For purposes of paragraph (b)(2) of this section, 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 § 1.752-4(b)(1)), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(*4*) *Obligations disregarded* - (*A*) *General rule*. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(*b*)(*3*) of this section) to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under § 1.752-2(b)(3) or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid 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. To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(*b*)(*3*) of this section), the obligation is disregarded and paragraph (b)(2) of this section and § 1.752-2 are applied as if the obligation did not exist.

(*B*) *Factors indicating plan to circumvent or avoid obligation.* In the case of an obligation to restore a deficit balance in a partner's capital account upon liquidation of a partnership, paragraphs (b)(2)(ii)(*c*)(*4*)(*B*)(*i*) through (*iv*) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation. For purposes of making determinations under this paragraph (b)(2)(ii)(*c*)(*4*), the weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The following factors are taken into consideration for purposes of this paragraph (b)(2):

(*i*) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(*ii*) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

(*iii*) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in § 1.704-1(b)(2)(iv) is negative other than when a transferee partner assumes the obligation.

(*iv*) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.

(*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 § 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 § 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).

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 § 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 § 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 § 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. References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).

(*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.

(*d*) *Partners that are look-through entities or members of a consolidated group* -

(*1*) *In general.* For purposes of applying paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section to a partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account. For purposes of applying paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section to a partner that is a member of a consolidated group (within the meaning of § 1.1502-1(h)), the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. See paragraph (b)(5) *Example 29* of this section.

(*2*) *Look-through entity.* For purposes of this paragraph (b)(2)(iii)(*d*), a *look-through entity* means -

(*i*) A partnership;

(*ii*) A subchapter S corporation;

(*iii*) A trust or an estate;

(*iv*) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§ 301.7701-1 through 301.7701-3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2); or

(*v*) A controlled foreign corporation if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. In such case, the controlled foreign corporation shall be treated as a look-through entity, but only with respect to allocations of income, gain, loss, or deduction (or items thereof) that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. See paragraph (b)(2)(iii)(*d*)(*6*) for the definition of indirect ownership.

(*3*) *Controlled foreign corporations.* For purposes of this section, the term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957(a) or section 953(c). In the case of a controlled foreign corporation that is a look-through entity, the tax attributes to be taken into account are those of any person that is a United States shareholder (as defined in paragraph (b)(2)(iii)(*d*)(*5*) of this section) of the controlled foreign corporation, or, if the United States shareholder is a look-through entity, a United States person that owns an interest in such shareholder directly or indirectly through one or more look-through entities.

(*4*) *United States person.* For purposes of this section, a *United States person* is a person described in section 7701(a)(30).

(*5*) *United States shareholder.* For purposes of this section, a *United States shareholder* is a person described in section 951(b) or section 953(c).

(*6*) *Indirect ownership.* For purposes of this section, indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 318, substituting the phrase “10 percent” for the phrase “50 percent” each time it appears.

(*e*) *De minimis rule* -

(*1*) *Partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012.* Except as provided in paragraph (b)(2)(iii)(*e*)(*2*) of this section, for purposes of applying this paragraph (b)(2)(iii), for partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012, the tax attributes of de minimis partners need not be taken into account. For purposes of this paragraph (b)(2)(iii)(*e*)(*1*), a de minimis partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. See paragraph (b)(2)(iii)(*d*)(*6*) of this section for the definition of indirect ownership.

(*2*) *Nonapplicability of de minimis rule.*

(*i*) *Allocations that become part of the partnership agreement on or after December 28, 2012.* Paragraph (b)(2)(iii)(*e*)(*1*) of this section does not apply to allocations that become part of the partnership agreement on or after December 28, 2012.

(*ii*) *Retest for allocations that become part of the partnership agreement prior to December 28, 2012.* If the de minimis partner rule of paragraph (b)(2)(iii)(*e*)(*1*) of this section was relied upon in testing the substantiality of allocations that became part of the partnership agreement before December 28, 2012, such allocations must be retested on the first day of the first partnership taxable year beginning on or after December 28, 2012, without regard to paragraph (b)(2)(iii)(*e*)(*1*) 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 that the partnership is considered to assume or take subject to), 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 that such partner is considered to assume or take subject to),

(*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 items described in (*6*) above and loss or deduction described in paragraphs (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. For liabilities assumed before June 24, 2003, references to liabilities in this paragraph (b)(2)(iv)(*b*) shall include only liabilities secured by the contributed or distributed property that are taken into account under section 752(a) and (b).

(*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 § 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 § 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, § 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 § 1.704-3 (e.g., tax allocations of precontribution gain or loss).

(*4*) *Exercise of noncompensatory options.* Solely for purposes of paragraph (b)(2)(iv)(*b*)(*2*) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in § 1.721-2(f)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option is the adjusted issue price of the debt and the accrued but unpaid qualified stated interest (as defined in § 1.1273-1(c)) on the debt immediately before the conversion, plus the fair market value of any property (other than the convertible debt) contributed to the partnership on the exercise of the option. See *Examples 31* through *35* of paragraph (b)(5) of this section.

(*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, as determined under paragraph (b)(2)(iv)(*h*) of this section. See *Example 33* of paragraph (b)(5) of this section.

(*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*) In connection with the grant of an interest in the partnership (other than a *de minimis* interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or

(*iv*) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or

(*v*) 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 examples 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.

(*6*) Notwithstanding paragraph (b)(2)(iv)(*f*)(*5*) of this section, the revaluation is required under § 1.721(c)-3(d)(1) as a condition of the application of the gain deferral method (as described in § 1.721(c)-3(b)) and is pursuant to an event described in this paragraph (b)(2)(iv)(*f*)(*6*). If an interest in a partnership is contributed to a section 721(c) partnership (as defined in § 1.721(c)-1(b)(14)), the partnership whose interest is contributed may revalue its property in accordance with this section. In this case, the revaluation by the partnership whose interest was contributed must occur immediately before the contribution. If a partnership that revalues its property pursuant to this paragraph owns an interest in another partnership, the partnership in which it owns an interest may also revalue its property in accordance with this section. When multiple partnerships revalue under this paragraph (b)(2)(iv)(f)(6), the revaluations occur in order from the lowest-tier partnership to the highest-tier partnership.

(*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. If 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. For purposes of the preceding sentence, additional first year depreciation deduction under section 168(k) is not a reasonable method.

(*h*) *Determinations of fair market value* -

(*1*) *In general.* 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.

(*2*) *Adjustments for noncompensatory options.* The value of partnership property as reflected on the books of the partnership must be adjusted to account for any outstanding noncompensatory options (as defined in § 1.721-2(f)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(*f*) or (*s*) of this section. If the fair market value of outstanding noncompensatory options (as defined in § 1.721-2(f)) as of the date of the adjustment exceeds the consideration paid to the partnership to acquire the options, then the value of partnership property as reflected on the books of the partnership must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the consideration paid to the partnership to acquire the outstanding noncompensatory options (as defined in § 1.721-2(f)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property as reflected on the books of the partnership must be increased by that excess to the extent of the unrealized loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized loss in proportion to their respective amounts of unrealized loss. However, any reduction or increase shall take into account the economic arrangement of the partners with respect to the property.

(*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 § 1.46-3 (or paragraph (a)(4)(iv) of § 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 tax credit from such property is recaptured by the partners under § 1.47-6.

(*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 relevent 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 precedecessors 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)(4)(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 § 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 § 1.708-1(b)(1)(iv) are disregarded for purposes of this paragraph (b)(2)(iv). See *Example 13* of paragraph (b)(5) of this section and the example in § 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 § 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.

(*3*) 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.

(*s*) *Adjustments on the exercise of a noncompensatory option.* A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in § 1.721-2(f)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid to the partnership to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the following requirements are met:

(*1*) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(*f*) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(*f*)(*1*) through (*f*)(*4*) of this section immediately after the exercise of the option.

(*2*) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(*s*)(*1*) of this section, the partnership first allocates any unrealized income, gain, or loss in partnership property (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income, gain, or loss (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, or loss in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date. For purposes of the preceding sentence, if the exercising partner's initial capital account as determined under § 1.704-1(b)(2)(iv)(*b*) and (*d*)(*4*) of this section would be less than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation. If the exercising partner's initial capital account, as determined under § 1.704-1(b)(2)(iv)(*b*) and (*d*)(*4*) of this section, would be greater than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only loss may be allocated to the exercising partner from partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss. However, any allocation must take into account the economic arrangement of the partners with respect to the property.

(*3*) If, after making the allocations described in paragraph (b)(2)(iv)(*s*)(*2*) of this section, the exercising partner's capital account does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account reflects the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or decrease in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(*s*)(*3*) must be allocated among the existing partners in accordance with the principles of this section. See *Example 32* of paragraph (b)(5) of this section.

(*4*) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(*s*)(*3*) of this section (see paragraph (b)(4)(x) of this section). See *Example 32* of paragraph (b)(5) of this section.

(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.

(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)(ii), (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.

(iv) *Special rule for creditable foreign tax expenditures.* In determining whether an allocation of a partnership item is in accordance with the partners' interests in the partnership, the allocation of the creditable foreign tax expenditure (CFTE) (as defined in paragraph (b)(4)(viii)(*b*) of this section) must be disregarded. This paragraph (b)(3)(iv) shall not apply to the extent the partners to whom such taxes are allocated reasonably expect to claim a deduction for such taxes in determining their U.S. tax liabilities.

(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 § 1.46-3 and paragraph (a)(4)(iv) of § 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 nonrecourse liabilities.* The rules for allocations attributable to nonrecourse liabilities are contained in § 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 under 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 § 1.1245-1, paragraph (f) of § 1.1250-1, paragraph (c) of § 1.1254-1, and paragraph (a) of § 1.47-6.

(viii) *Allocation of creditable foreign taxes* -

(*a*) *In general.* Allocations of creditable foreign taxes do not have substantial economic effect within the meaning of paragraph (b)(2) of this section and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. See paragraph (b)(3)(iv) of this section. An allocation of a creditable foreign tax expenditure (CFTE) will be deemed to be in accordance with the partners' interests in the partnership if -

(*1*) The CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) to each partner and reported on the partnership return in proportion to the partners' CFTE category shares of income to which the CFTE relates; and

(*2*) Allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to a partner pursuant to paragraph (b)(4)(viii)(*a*)(*1*) of this section are valid.

(*b*) *Creditable foreign tax expenditures* (*CFTEs*). For purposes of this section, a CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under section 901(a) or an applicable U.S. income tax treaty. A foreign tax is a CFTE for these purposes without regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such tax. Foreign taxes paid or accrued by a partner with respect to a distributive share of partnership income, and foreign taxes deemed paid under section 902 or 960 by a corporate partner with respect to stock owned, directly or indirectly, by or for a partnership, are not taxes paid or accrued by a partnership and, therefore, are not CFTEs subject to the rules of this section. See paragraphs (e) and (f) of § 1.901-2 for rules for determining when and by whom a foreign tax is paid or accrued.

(*c*) *Income to which CFTEs relate.* -

(*1*) *In general.* For purposes of paragraph (b)(4)(viii)(*a*) of this section, CFTEs are related to net income in the partnership's CFTE category or categories to which the CFTE is allocated and apportioned in accordance with the rules of paragraph (b)(4)(viii)(*d*) of this section. Paragraph (b)(4)(viii)(*c*)(*2*) of this section provides rules for determining a partnership's CFTE categories. Paragraph (b)(4)(viii)(*c*)(*3*) of this section provides rules for determining the net income in each CFTE category. Paragraph (b)(4)(viii)(*c*)(*4*) of this section provides rules for determining a partner's CFTE category share of income, including rules that require adjustments to net income in a CFTE category for purposes of determining the partners' CFTE category share of income with respect to certain CFTEs. Paragraph (b)(4)(viii)(*c*)(*5*) of this section provides a special rule for allocating CFTEs when a partnership has no net income in a CFTE category.

(*2*) *CFTE category* -

(*i*) *Income from activities.* A CFTE category is a category of net income (or loss) attributable to one or more activities of the partnership. Net income (or loss) from all the partnership's activities shall be included in a single CFTE category unless the allocation of net income (or loss) from one or more activities differs from the allocation of net income (or loss) from other activities, in which case income from each activity or group of activities that is subject to a different allocation shall be treated as net income (or loss) in a separate CFTE category.

(*ii*) *Different allocations.* Different allocations of net income (or loss) generally will result from provisions of the partnership agreement providing for different sharing ratios for net income (or loss) from separate activities. Different allocations of net income (or loss) from separate activities generally will also result if any partnership item is shared in a different ratio than any other partnership item. A guaranteed payment described in paragraph (b)(4)(viii)(*c*)(*4*)(*ii*) of this section, gross income allocation, or other preferential allocation will result in different allocations of net income (or loss) from separate activities only if the amount of the payment or the allocation is determined by reference to income from less than all of the partnership's activities.

(*iii*) *Activity.* Whether a partnership has one or more activities, and the scope of each activity, is determined in a reasonable manner taking into account all the facts and circumstances. In evaluating whether aggregating or disaggregating income from particular business or investment operations constitutes a reasonable method of determining the scope of an activity, the principal consideration is whether the proposed determination has the effect of separating CFTEs from the related foreign income. Relevant considerations include whether the partnership conducts business in more than one geographic location or through more than one entity or branch, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. In addition, income from a divisible part of a single activity is treated as income from a separate activity if necessary to prevent separating CFTEs from the related foreign income, such as when income from divisible parts of a single activity is subject to different allocations. See, for example, paragraph (b)(4)(viii)(*c*)(*3*)(*iv*) of this section (special allocations related to disregarded payments can give rise to subdivision of an activity into divisible parts). A guaranteed payment, gross income allocation, or other preferential allocation of income that is determined by reference to all the income from a single activity generally will not result in the division of an activity into divisible parts. See *Example 22* in paragraph (b)(5)(xxii) of this section and *Example 1* in paragraph (b)(6)(i) of this section. The partnership's activities must be determined consistently from year to year absent a material change in facts and circumstances.

(*3*) *Net income in a CFTE category* -

(*i*) *In general.* A partnership computes net income in a CFTE category as follows: First, the partnership determines for U.S. Federal income tax purposes all of its partnership items, including items of gross income, gain, loss, deduction, and expense, and items allocated pursuant to section 704(c). For the purpose of this paragraph (b)(4)(viii)(*c*)(*3*)(*i*), the items of the partnership are determined without regard to any adjustments under section 743(b) that its partners may have to the basis of property of the partnership. However, if the partnership is a transferee partner that has a basis adjustment under section 743(b) in its capacity as a direct or indirect partner in a lower-tier partnership, the partnership does take such basis adjustment into account. Second, the partnership must assign those partnership items to its activities pursuant to paragraph (b)(4)(viii)(*c*)(*3*)(*ii*) of this section. Third, partnership items attributable to each activity are aggregated within the relevant CFTE category as determined under paragraph (b)(4)(viii)(*c*)(*2*) of this section in order to compute the net income in a CFTE category.

(*ii*) *Assignment of partnership items to activities.* The items of gross income attributable to an activity must be determined in a consistent manner under any reasonable method taking into account all the facts and circumstances. Except as otherwise provided in paragraph (b)(4)(viii)(*c*)(*3*)(*iii*) of this section, expenses, losses, or other deductions must be allocated and apportioned to gross income attributable to an activity in accordance with the rules of §§ 1.861-8 and 1.861-8T. Under the rules §§ 1.861-8 and 1.861-8T, if an expense, loss, or other deduction is allocated to gross income from more than one activity, such expense, loss, or deduction must be apportioned among each such activity using a reasonable method that reflects to a reasonably close extent the factual relationship between the deduction and the gross income from such activities. See § 1.861-8T(c). For the effect of disregarded payments in determining the amount of net income attributable to an activity, see paragraph (b)(4)(viii)(*c*)(*3*)(*iv*) of this section.

(*iii*) *Interest expense and research and experimental expenditures.* The partnership's interest expense and research and experimental expenditures described in section 174 may be allocated and apportioned under any reasonable method, including but not limited to the methods prescribed in §§ 1.861-9 through 1.861-13T (interest expense) and § 1.861-17 (research and experimental expenditures).

(*iv*) *Disregarded payments.* An item of gross income is assigned to the activity that generates the item of income that is recognized for U.S. Federal income tax purposes. Consequently, disregarded payments are not taken into account in determining the amount of net income attributable to an activity, although a special allocation of income used to make a disregarded payment may result in the subdivision of an activity into divisible parts. See paragraph (b)(4)(viii)(*c*)(*2*)(*iii*) of this section, *Example 24* in paragraph (b)(5)(xxiv) of this section, and *Examples 2* and *3* in paragraphs (b)(6)(ii) and (iii), respectively, of this section (relating to inter-branch payments).

(*4*) *CFTE category share of income* -

(*i*) *In general.* CFTE category share of income means the portion of the net income in a CFTE category, determined in accordance with paragraph (b)(4)(viii)(*c*)(*3*) of this section as modified by paragraphs (b)(4)(viii)(c)(*4*)(*ii*) through (*iv*) of this section, that is allocated to a partner. To the extent provided in paragraph (b)(4)(viii)(*c*)(*4*)(*ii*) of this section, a guaranteed payment is treated as an allocation to the recipient of the guaranteed payment for this purpose. If more than one partner receives positive income allocations (income in excess of expenses) from a CFTE category, which in the aggregate exceed the total net income in the CFTE category, then such partner's CFTE category share of income equals the partner's positive income allocation from the CFTE category, divided by the aggregate positive income allocations from the CFTE category, multiplied by the net income in the CFTE category. Paragraphs (b)(4)(viii)(*c*)(*4*)(*ii*) through (*iv*) of this section require adjustments to the net income in a CFTE category for purposes of determining the partners' CFTE category share of income if one or more foreign jurisdictions impose a tax that provides for certain exclusions or deductions from the foreign taxable base. Such adjustments apply only with respect to CFTEs attributable to the taxes that allow such exclusions or deductions. Thus, net income in a CFTE category may vary for purposes of applying paragraph (b)(4)(viii)(*a*)(*1*) of this section to different CFTEs within that CFTE category.

(*ii*) *Guaranteed payments.* Except as otherwise provided in this paragraph (b)(4)(viii)(*c*)(*4*)(*ii*), solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(*a*)(*1*) of this section, net income in the CFTE category from which a guaranteed payment (within the meaning of section 707(c)) is made is increased by the amount of the guaranteed payment that is deductible for U.S. Federal income tax purposes, and such amount is treated as an allocation to the recipient of such guaranteed payment for purposes of determining the partners' CFTE category shares of income. If a foreign tax allows (whether in the current or in a different taxable year) a deduction from its taxable base for a guaranteed payment, then solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of CFTEs that are attributable to that foreign tax, net income in the CFTE category is increased only to the extent that the amount of the guaranteed payment that is deductible for U.S. Federal income tax purposes exceeds the amount allowed as a deduction for purposes of the foreign tax, and such excess is treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners' CFTE category shares of income. See *Example 1* in paragraph (b)(6)(i) of this section.

(*iii*) *Preferential allocations.* To the extent that a foreign tax allows (whether in the current or in a different taxable year) a deduction from its taxable base for an allocation (or distribution of an allocated amount) to a partner, then solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of CFTEs that are attributable to that foreign tax, the net income in the CFTE category from which the allocation is made is reduced by the amount of the allocation, and that amount is not treated as an allocation for purposes of determining the partners' CFTE category shares of income. See *Example 1* in paragraph (b)(6)(i) of this section.

(*iv*) *Foreign law exclusions due to status of partner.* If a foreign tax excludes an amount from its taxable base as a result of the status of a partner, then solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of CFTEs that are attributable to that foreign tax, the net income in the relevant CFTE category is reduced by the excluded amounts that are allocable to such partners. See *Example 27* in paragraph (b)(5)(xxvii) of this section.

(*v*) *Adjustments related to section 901(m).* If one or more assets owned by a partnership are relevant foreign assets (or RFAs) with respect to a foreign income tax, then, solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of CFTEs with respect to that foreign income tax, the net income in a CFTE category that includes partnership items of income, deduction, gain, or loss attributable to the RFA shall be increased by the amount described in paragraph (b)(4)(viii)(*c*)(*4*)(*vi*) of this section and reduced by the amount described in paragraph (b)(4)(viii)(*c*)(*4*)(*vii*) of this section. Similarly, a partner's CFTE category share of income shall be increased by the portion of the amount described in paragraph (b)(4)(viii)(*c*)(*4*)(*vi*) of this section that is allocated to the partner under § 1.901(m)-5(d) and reduced by the portion of the amount described in paragraph (b)(4)(viii)(*c*)(*4*)(*vii*) of this section that is allocated to the partner under § 1.901(m)-5(d). The principles of this paragraph (b)(4)(viii)(*c*)(*4*)(*v*) apply similarly when a partnership owns an RFA indirectly through one or more other partnerships. For purposes of this paragraph (b)(4)(viii)(*c*)(*4*)(*v*) and paragraphs (b)(4)(viii)(*c*)(*4*)(*vi*) and (b)(4)(viii)(*c*)(*4*)(*vii*) of this section, basis difference is defined in § 1.901(m)-4, cost recovery amount is defined in § 1.901(m)-5(b)(2), disposition amount is defined in § 1.901(m)-5(c)(2), foreign income tax is defined in § 1.901(m)-1(a)(26), RFA is defined in § 1.901(m)-2(c), U.S. disposition gain is defined in § 1.901(m)-1(a)(52), and U.S. disposition loss is defined in § 1.901(m)-1(a)(53).

(*vi*) *Adjustment amounts for RFAs with a positive basis difference.* With respect to RFAs with a positive basis difference, the amount referenced in paragraph (b)(4)(viii)(*c*)(*4*)(*v*) of this section is the sum of any cost recovery amounts and disposition amounts attributable to U.S. disposition loss that correspond to partnership items that are included in the net income in the CFTE category and that are taken into account for the U.S. taxable year of the partnership under § 1.901(m)-5(d).

(*vii*) *Adjustment amounts for RFAs with a negative basis difference.* With respect to RFAs with a negative basis difference, the amount referenced in paragraph (b)(4)(viii)(*c*)(*4*)(*v*) of this section is the sum of any cost recovery amounts and disposition amounts attributable to U.S. disposition gain that correspond to partnership items that are included in the net income in the CFTE category and that are taken into account for the U.S. taxable year of the partnership under § 1.901(m)-5(d).

(*5*) *No net income in a CFTE category.* If a CFTE is allocated or apportioned to a CFTE category that does not have net income for the year in which the foreign tax is paid or accrued, the CFTE shall be deemed to relate to the aggregate of the net income (disregarding net losses) recognized by the partnership in that CFTE category in each of the three preceding taxable years. Accordingly, except as provided below, such CFTE must be allocated in the current taxable year in the same proportion as the allocation of the aggregate net income for the prior three-year period in order to satisfy the requirements of paragraph (b)(4)(viii)(*a*)(*1*) of this section. If the partnership does not have net income in the applicable CFTE category in either the current year or any of the previous three taxable years, the CFTE must be allocated in the same proportion that the partnership reasonably expects to allocate the aggregate net income (disregarding net losses) in the CFTE category for the succeeding three taxable years. If the partnership does not reasonably expect to have net income in the CFTE category for the succeeding three years and the partnership has net income in one or more other CFTE categories for the year in which the foreign tax is paid or accrued, the CFTE shall be deemed to relate to such other net income and must be allocated in proportion to the allocations of such other net income. If any CFTE is not allocated pursuant to the above provisions of this paragraph then the CFTE must be allocated in proportion to the partners' outstanding capital contributions.

(*d*) *Allocation and apportionment of CFTEs to CFTE categories.* -

(*1*) *In general.* CFTEs are allocated and apportioned to CFTE categories in accordance with § 1.861-20 by treating each CFTE category as a statutory grouping (with no residual grouping). See paragraphs (b)(6)(ii) and (iii) of this section (*Examples 2* and *3*), which illustrate the application of this paragraph (b)(4)(viii)(*d*)(*1*) in the case of serial disregarded payments subject to withholding tax. In addition, if as described in § 1.861-20(e), foreign law does not provide for the direct allocation or apportionment of expenses, losses or other deductions allowed under foreign law to a CFTE category of income, then such expenses, losses or other deductions must be allocated and apportioned to gross income as determined under foreign law in a manner that is consistent with the allocation and apportionment of such items for purposes of determining the net income in the CFTE categories for Federal income tax purposes pursuant to paragraph (b)(4)(viii)(*c*)(*3*) of this section.

(*2*) *Timing and base differences.* A foreign tax imposed on an item that would be income under U.S. tax principles in another year (a timing difference) is allocated to the CFTE category that would include the income if the income were recognized for U.S. tax purposes in the year in which the foreign tax is imposed. A foreign tax imposed on an item that would not constitute income under U.S. tax principles in any year (a base difference) is allocated to the CFTE category that includes the partnership items attributable to the activity with respect to which the foreign tax is imposed. See paragraph (b)(5) *Example 23* of this section.

(*3*) *Special rules for inter-branch payments.* For rules relating to foreign tax paid or accrued in partnership taxable years beginning before January 1, 2012, in respect of certain inter-branch payments, see 26 CFR 1.704-1(b)(4)(viii)(*d*)(*3*) (revised as of April 1, 2011).

(ix) *Allocations with respect to noncompensatory options* -

(*a*) *In general.* A partnership agreement may grant to a partner that exercises a noncompensatory option (as defined in § 1.721-2(f)) a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid to the partnership to acquire and exercise the option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect because, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. However, allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership only if -

(*1*) The holder of the noncompensatory option is not treated as a partner under § 1.761-3;

(*2*) The partnership agreement requires that, while a noncompensatory option is outstanding, the partnership comply with the rules of paragraph (b)(2)(iv)(*f*) of this section and that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(*s*) of this section; and

(*3*) All material allocations and capital account adjustments under the partnership agreement would be respected under section 704(b) if there were no outstanding noncompensatory options issued by the partnership. See *Examples 31* through *35* of paragraph (b)(5) of this section.

(*b*) *Substantial economic effect under sections 168(h) and 514(c)(9)(E)(i)(ll).* An allocation of partnership income, gain, loss, or deduction to the partners will be deemed to have substantial economic effect for purposes of sections 168(h) and 514(c)(9)(E)(i)(ll) if -

(*1*) The allocation would meet the substantial economic effect requirements of paragraph (b)(2) of this section if there were no outstanding noncompensatory options issued by the partnership; and

(*2*) The partnership satisfies the requirements of paragraph (b)(4)(ix)(*a*)(*1*), (*2*), and (*3*) of this section.

(x) *Corrective allocations* -

(*a*) - *In general.* If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(*s*)(*3*) of this section (a capital account reallocation), then the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the required allocations are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item. See *Example 32* of paragraph (b)(5) of this section.

(*b*) *Timing.* Section 706 and the regulations and principles thereunder apply in determining the items of income, gain, loss, and deduction that may be subject to corrective allocation.

(*c*) *Allocation of gross income and gain and gross loss and deduction.* If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross income and gain as to further take into account the capital account reallocation.

(xi) *Section 163(j) excess items.* Allocations of section 163(j) excess items as defined in § 1.163(j)-6(b)(6) do not have substantial economic effect under paragraph (b)(2) of this section and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. See paragraph (b)(3)(iv) of this section. Allocations of section 163(j) excess items will be deemed to be in accordance with the partners' interests in the partnership if such allocations are made in accordance with § 1.163(j)-6(f).

(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 accounts 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 through 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.

	A	**B**
Capital account upon formation	$40,000	$40,000
Less: year 1 cost recovery deduction	(20,000)	0
Capital account at end of year 1	$20,000	$40,000

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.

	A	**B**
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery deduction	(25,000)	0
Capital account at end of year 2	($5,000)	$40,000

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.

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

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.

	A	**B**
Capital account at beginning of year 2	$20,000	$40,000
Less: expected future distribution	(5,000)	(5,000)
Less: year 2 cost recovery deduction	(20,000)	(0)
Hypothetical capital account at end of year 2	($5,000)	$35,000

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)(2)(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)(ii)(*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 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**	
	Tax	**Book**	**Tax**	**Book**
Capital account upon formation	$10,000	$10,000	$3,000	$10,000
Plus: gain	1,000	1,000	8,000	1,000
Capital account at end of year 1	$11,000	$11,000	$11,000	$11,000

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:

	Y	**Z**	**LK**
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	4,500	9,000	4,500
Capital account at end of year 2	$10,000	$20,000	$10,000

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 § 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:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	2,500	5,000	2,500
Capital account at end of the year 2	$8,000	$16,000	$8,000

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 § 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 § 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.

	MC		**RW**		**SK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	15,000	0	15,000	0	0	0
Capital account following sale	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000

(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.

	MC		**RW**		**SK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	23,000	8,000	23,000	8,000	8,000	8,000
Capital account following sale	$33,000	$33,000	$33,000	$33,000	$33,000	$33,000

(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.

	MC		**RW**		**SK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	12,000	0	12,000	0	0	0
Less: loss	0	(2,000)	0	(2,000)	0	(2,000)
Capital account following sale	$22,000	$23,000	$22,000	$23,000	$25,000	$25,000

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 § 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.

	MC	**RW**	**SK**
Capital account before adjustment	$10,000	$10,000	$25,000
Deemed sale adjustment	23,000	23,000	8,000
Less: distribution	(24,667)	(24,667)	(24,667)
Capital account after distribution	$8,333	$8,333	$8,333

(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).

	MC		**RW**		**SK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: basis adjustment	15,000	0	0	0	0	0
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account account after liquidation	0	0	$10,000	$25,000	$25,000	$25,000

(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.

	MC		**RW**		**SK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Less: distribution	(25,000)	(25,000)	0	0	0	0

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account after liquidation	($15,000)	0	$10,000	$25,000	$25,000	$25,000

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.

	JB	DK
Capital account upon formation	$13,500	$1,500
Less: year 1 net loss	(10,800)	(1,200)
Capital account at end of year 1	$2,700	$300

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.

	JB	DK
Capital account at beginning of year 1	$2,700	$300
Less: year 2 net loss	(10,800)	(1,200)
Capital account at end of year 2	($8,100)	($900)

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*), 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.

	WM	***JL***
Capital account upon formation	$300,000	$300,000
Less: Net loss for years 1 and 2	(*200,000*)	(*200,000*)
Capital account at end of year 2	$100,000	$100,000

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.

	WM		**JL**		**MK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	200,000	0	200,000	0	0	0
Capital account before liquidation	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000

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.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	300,000	100,000	300,000	100,000	100,000	100,000
Capital account before liquidation	$400,000	$400,000	$400,000	$400,000	$400,000	$400,000

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:

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	125,000	0	125,000	0	0	0
Less: loss	0	(50,000)	0	(50,000)	0	(50,000)
Capital account before liquidation	$225,000	$250,000	$225,000	$250,000	$300,000	$250,000

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 § 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.

	WM		**JL**		**MK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less Loss	0	(143,333)	0	(143,333)	(30,000)	(143,333)
Capital account before liquidation	$100,000	$156,667	$100,000	$156,667	$270,000	$156,667

(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.

	WM		**JL**		**MK**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less: recovery/depreciation deduction for year 3	0	(100,000)	0	(100,000)	(100,000)	(100,000)
Capital account at end of year 3	$100,000	$200,000	$100,000	$200,000	$200,000	$200,000

(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.

	WM		JL		MK	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
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.

	WM		JL		MK	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(100,000)	0	(100,000)	(100,000)	(100,000)
(b) recovery/depreciation deduction for property bought in year 3	(100,000)	(100,000)	0	0	0	0
Capital account at end of year 3	0	$100,000	$100,000	$200,000	$200,000	$200,000

(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.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) loss on property bought in year 1	0	(70,000)	0	(70,000)	(10,000)	(70,000)
(b) loss on property bought in year 3	(20,000)	(20,000)	0	0	0	0
Capital account before liquidation	($20,000)	$10,000	$100,000	$130,000	$190,000	$130,000

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.

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

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.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 5	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000
Less: loss	0	(26,667)	0	(26,667)	0	(26,667)
Capital account before liquidation	($50,000)	($36,667)	$75,000	$88,333	$115,000	$88,333

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 depreciations) 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 § 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.

Example 20.

(i) A and B form AB, an eligible entity (as defined in § 301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and earns income from passive investments in country X. Country X imposes a 40 percent tax on business M income, which tax is a CFTE, but exempts from tax income from passive investments. In 2007, AB earns $100,000 of income from business M and $30,000 from passive investments and pays or accrues $40,000 of country X taxes. For purposes of section 904(d), the income from business M is general limitation income and the income from the passive investments is passive income. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 60 percent to A and 40 percent to B, and all partnership items, including CFTEs, from passive investments are allocated 80 percent to A and 20 percent to B. Accordingly, A is allocated 60 percent of the business M income ($60,000) and 60 percent of the country X taxes ($24,000), and B is allocated 40 percent of the business M income ($40,000) and 40 percent of the country X taxes ($16,000). The income from the passive investments is allocated $24,000 to A and $6,000 to B. Assume that allocations of all items other than CFTEs are valid.

(ii) Because the partnership agreement provides for different allocations of the net income attributable to business M and the passive investments, the net income attributable to each is income in a separate CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. AB must determine the net income in each CFTE category and the CFTEs allocable to each CFTE category. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the net income in the business M CFTE category is the $100,000 attributable to business M and the net income in the passive investments CFTE category is the $30,000 attributable to the passive investments. Under paragraph (b)(4)(viii)(*d*) of this section, the $40,000 of country X taxes is allocated to the business M CFTE category and no portion of the country X taxes is allocated to the passive investments CFTE category. Therefore, the $40,000 of country X taxes are related to the $100,000 of net income in the business M CFTE category. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the net income from the business M CFTE category 60 percent to A and 40 percent to B, and the country X taxes 60 percent to A and 40 percent to B, the allocations of the CFTEs are in proportion to the distributive shares of income to which the CFTEs relate. Because AB satisfies the requirement of paragraph (b)(4)(viii) of this section, the allocations of the country X taxes are deemed to be in accordance with the partners' interests in the partnership. Because the business M income is general limitation income, all $40,000 of taxes are attributable to the general limitation category. See § 1.904-6.

Example 21.

(i) A and B form AB, an eligible entity (as defined in § 301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. Country X imposes a 40 percent tax on business M income, country Y imposes a 20 percent tax on business N income, and the country X and country Y taxes are CFTEs. In 2007, AB has $100,000 of income from business M and $50,000 of income from business N. Country X imposes $40,000 of tax on the income from business M and country Y imposes $10,000 of tax on the income of business N. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including CFTEs, from business N are split evenly between A and B (50 percent each). Accordingly, A is allocated 75 percent of the income from business M ($75,000), 75 percent of the country X taxes ($30,000), 50 percent of the income from business N ($25,000), and 50 percent of the country Y taxes ($5,000). B is allocated

25 percent of the income from business M ($25,000), 25 percent of the country X taxes ($10,000), 50 percent of the income from business N ($25,000), and 50 percent of the country Y taxes ($5,000). Assume that allocations of all items other than CFTEs are valid. The income from business M and business N is general limitation income for purposes of section 904(d).

(ii) Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each business is income in a separate CFTE category even though all of the income is in the general limitation category for section 904(d) purposes. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the net income in the business M CFTE category is the $100,000 attributable to business M and the net income in the business N CFTE category is $50,000 attributable to business N. Under paragraph (b)(4)(viii)(*d*) of this section, the $40,000 of country X taxes is allocated to the business M CFTE category and the $10,000 of country Y taxes is allocated to the business N CFTE category. Therefore, the $40,000 of country X taxes are related to the $100,000 of net income in the business M CFTE category and the $10,000 of country Y taxes are related to the $50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the $40,000 of country X taxes in the same proportion as the net income in the business M CFTE category, and the $10,000 of country Y taxes in the same proportion as the net income in the business N CFTE category, the allocations of the country X taxes and the country Y taxes are in proportion to the distributive shares of income to which the foreign taxes relate. Because AB satisfies the requirements of paragraph (b)(4)(viii) of this section, the allocations of the country X and country Y taxes are deemed to be in accordance with the partners' interests in the partnership.

Example 22.

(i) The facts are the same as in *Example 21,* except that the partnership agreement provides for the following allocations. Depreciation attributable to machine X, which is used in business M, is allocated 100 percent to A. B is allocated the first $20,000 of gross income attributable to business N, which allocation does not result in a deduction under foreign law. All remaining items, except CFTEs, are allocated 50 percent to A and 50 percent to B. For 2007, assume that business M generates $120,000 of income, before taking into account depreciation attributable to machine X. The total amount of depreciation attributable to machine X is $20,000, which results in $100,000 of net income attributable to business M for U.S. and country X tax purposes. Business N generates $70,000 of gross income and has $20,000 of expenses, resulting in $50,000 of net income for U.S. and country Y tax purposes. Pursuant to the partnership agreement, A is allocated $40,000 of the net income attributable to business M ($60,000 of business M income less $20,000 of depreciation attributable to machine X), and $15,000 of the net income attributable to business N. B is allocated $60,000 of the net income attributable to business M and $35,000 of the net income attributable to business N ($20,000 of gross income, plus $15,000 of net income).

(ii) As a result of the special allocations, the net income attributable to business M ($100,000) is allocated 40 percent to A and 60 percent to B. The net income attributable to business N ($50,000) is allocated 30 percent to A and 70 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income from each of businesses M and N is income in a separate CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the net income in the business M CFTE category is the $100,000 of net income attributable to business M and the net income in the business N CFTE category is the $50,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $40,000 of country X taxes is allocated to the business M CFTE category and the $10,000 of country Y taxes is allocated to the business N CFTE category. Therefore, the $40,000 of country X taxes relates to the $100,000 of net income in the business M CFTE and the $10,000 of country Y taxes relates to the $50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. The allocations of the country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 40 percent to A and 60 percent to B. The allocations of the country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 30 percent to A and 70 percent to B.

(iii) Assume that for 2008, all the facts are the same as in paragraph (i) of this *Example 22,* except that business M generates $60,000 of income before taking into account depreciation attributable to machine X and country X imposes $16,000 of tax on the $40,000 of net income attributable to business M. Pursuant to the partnership agreement, A is allocated 25 percent of the income from business M ($10,000), and B is allocated 75 percent of the income from business M ($30,000). Allocations of the country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 25 percent to A and 75 percent to B.

Example 23.

(i) The facts are the same as in *Example 21,* except that AB does not actually receive the $50,000 of income accrued in 2007 with respect to business N until 2008 and AB accrues and receives an additional $100,000 with respect to business N in 2008. Also assume that A, B, and AB each report taxable income on an accrual basis for U.S. tax purposes and AB reports taxable income using the cash receipts and disbursements method of accounting for country X and country Y purposes. In 2007, AB pays or accrues country X taxes of $40,000. In 2008, AB pays or accrues country Y taxes of $30,000. Pursuant to the partnership agreement, in 2007, A is allocated 75 percent of business M income ($75,000) and country X taxes ($30,000) and 50 percent of business N income ($25,000). B is allocated 25 percent of business M income ($25,000) and country X taxes ($10,000) and 50 percent of business N income ($25,000). In 2008, A and B are each allocated 50 percent of the business N income ($50,000) and country Y taxes ($15,000).

(ii) For 2007, the $40,000 of country X taxes paid or accrued by AB relates to the $100,000 of net income in the business M CFTE category. No portion of the country X taxes paid or accrued in 2007 relates to the $50,000 of net income in the business N CFTE category. For 2008, the net income in the business N CFTE category is the $100,000 attributable to business N. See paragraph (b)(4)(viii)(*c*)(*3*) of this section. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, $20,000 of the country Y tax paid or accrued in 2008 is allocated to the business N CFTE category. The remaining $10,000 of country Y tax is allocated to the business N CFTE category under paragraph (b)(4)(viii)(*d*)(*2*) of this section (relating to timing differences). Therefore, the $30,000 of country Y taxes paid or accrued by AB in 2008 is related to the $100,000 of net income in the business N CFTE category for 2008. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the $40,000 of country X taxes and the $30,000 of country Y taxes in proportion to the distributive shares of income to which the taxes relate, the allocations of the country X and country Y taxes satisfy the requirements of paragraphs (b)(4)(viii)(*a*)(*1*) and (*2*) of this section and the allocations of the country X and Y taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section.

Example 24.

(i) The facts are the same as in *Example 21,* except that businesses M and N are conducted by entities (DE1 and DE2, respectively) that are corporations for country X and Y tax purposes and disregarded entities for U.S. Federal income tax purposes. Also, assume that DE1 makes payments of $75,000 during 2012 to DE2 that are deductible by DE1 for country X tax purposes and includible in income of DE2 for country Y tax purposes. As a result of such payments, DE1 has taxable income of $25,000 for country X purposes on which $10,000 of taxes are imposed and DE2 has taxable income of $125,000 for country Y purposes on which $25,000 of taxes are imposed. For U.S. Federal income tax purposes, $100,000 of AB's income is attributable to the activities of DE1 and $50,000 of AB's income is attributable to the activities of DE2. Pursuant to the partnership agreement, all partnership items from business M, excluding CFTEs paid or accrued by business M, are allocated 75% to A and 25% to B, and all partnership items from business N, excluding CFTEs paid or accrued by business N, are split evenly between A and B (50% each). Accordingly, A is allocated 75% of the income from business M ($75,000), and 50% of the income from business N ($25,000). B is allocated 25% of the income from business M ($25,000), and 50% of the income from business N ($25,000).

(ii) Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each of business M and business N is income in separate CFTE categories. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the $100,000 of net income attributable to business M is in the business M CFTE category and the $50,000 of net income attributable to business N is in the business N CFTE category. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $10,000 of country X taxes is allocated to the business M CFTE category and $10,000 of the country Y taxes is allocated to the business N CFTE category. The additional $15,000 of country Y tax imposed with respect to the inter-branch payment is assigned to the business M CFTE category because for U.S. Federal income tax purposes, the related $75,000 of income that country Y is taxing is in the business M CFTE category. Therefore, $25,000 of taxes ($10,000 of country X taxes and $15,000 of the country Y taxes) is related to the $100,000 of net income in the business M CFTE category and the other $10,000 of country Y taxes is related to the $50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. The allocations of country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 75% to A and 25% to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if $15,000 of such taxes is allocated 75% to A and 25% to B and the other $10,000 of such taxes is allocated 50% to A and 50% to B. No inference is intended with respect to the application of other provisions to arrangements that involve disregarded payments.

(iii) Assume that the facts are the same as in paragraph (i) of this *Example 24,* except that in order to reflect the $75,000 payment from DE1 to DE2, the partnership agreement allocates $75,000 of the income attributable to business M equally between A and B (50% each). In order to prevent separating the CFTEs from the related foreign income, the $75,000 payment is treated as a divisible part of the business M activity and, therefore, a separate activity. See paragraph (b)(4)(viii)(*c*)(*2*)(*iii*) of this section. Because items from the disregarded payment and business N are both shared equally between A and B, the disregarded payment activity and the business N activity are treated as a single CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*)(*i*) of this section. Accordingly, $25,000 of net income attributable to business M is in the business M CFTE category and $75,000 of income of business M attributable to the disregarded payment and the $50,000 of net income attributable to business N are in the business N CFTE category. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $10,000 of country X taxes is allocated to the business M CFTE category and all $25,000 of the country Y taxes is allocated to the business N CFTE category. The allocations of country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 75% to A and 25% to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 50% to A and 50% to B.

Example 25.

[Reserved]. For further guidance, see § 1.704-1T(b)(5) *Example 25.*

Example 26.

(i) A and B form AB, an eligible entity (as defined in § 301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. A, a U.S. corporation, contributes a building with a fair market value of $200,000 and an adjusted basis of $50,000 for both U.S. and country X purposes. The building contributed by A is used in business M. B, a country X corporation, contributes $800,000 cash. The AB partnership agreement provides that AB will make allocations under section 704(c) using the traditional method under § 1.704-3(b) and that all other items, excluding creditable foreign taxes, will be allocated 20 percent to A and 80 percent to B. The partnership agreement provides that creditable foreign taxes will be allocated in proportion to the partners' distributive shares of net income in each CFTE category, which shall be determined by taking into accounts items allocated pursuant to section 704(c). Country X and Country Y impose tax at a rate of 20 percent and 40 percent, respectively, and such taxes are CFTEs. In 2007, AB sells the building contributed by A for $200,000, thereby recognizing taxable income of $150,000 for U.S. and country X purposes, and recognizes $250,000 of other income from the operation of business M. AB pays or accrues $80,000 of country X tax on such income. Also in 2007, business N recognizes $100,000 of taxable income for U.S. and country Y purposes and pays or accrues $40,000 of country Y tax. Pursuant to the partnership agreement, A is allocated $200,000 of business M income ($150,000 of taxable income in accordance with section 704(c) and $50,000 of other business M income) and $40,000 of country X tax, and 20 percent of both business N income ($20,000) and country Y tax ($8,000). B is allocated $200,000 of business M income and $40,000 of country X tax and 80 percent of both the business N income ($80,000) and country Y tax ($32,000). Assume that allocations of all items other than CFTEs are valid.

(ii) The net income attributable to business M ($400,000) is allocated 50 percent to A and 50 percent to B while the net income attributable to business N ($100,000) is allocated 20 percent to A and 80 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each activity is income in a separate CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the net income in the business M CFTE category is the $400,000 of net income attributable to business M and the net income in the business N CFTE category is the $100,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $80,000 of country X tax is allocated to the business M CFTE category and the $40,000 of country Y tax is allocated to the business N CFTE category. Therefore, the $80,000 of country X tax relates to the $400,000 of net income in the business M CFTE category and the $40,000 of country Y tax relates to the $100,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the $80,000 of country X taxes and $40,000 of country Y taxes in proportion to the distributive shares of income to which such taxes relate, the allocations are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section.

Example 27.

(i) A, a U.S. citizen, and B, a country X citizen, form AB, a country X eligible entity (as defined in § 301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB's only activity is business M, which it operates in country X. Country X imposes a 40 percent tax on the portion of AB's business M income that is the allocable share of AB's owners that are not citizens of country X, which tax is a CFTE. The partnership agreement provides that all partnership items, excluding CFTEs, from business M are allocated 40 percent to A and 60 percent to B. CFTEs are allocated 100 percent to A. In 2007, AB earns $100,000 of net income from business M and pays or accrues $16,000 of country X taxes on A's allocable share of AB's income ($40,000). Pursuant to the partnership agreement, A is allocated 40 percent of the business M income ($40,000) and 100 percent of the country X taxes ($16,000), and B is allocated 60 percent of the business M income ($60,000) and no country X taxes. Assume that allocations of all items other than CFTEs are valid.

(ii) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(*c*)(*2*). Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the $40,000 of business M income that is allocated to A is included in the single CFTE category. Under paragraph (b)(4)(viii)(*c*)(*3*)(*ii*) of this section, no portion of the $60,000 allocated to B is included in the single CFTE category.

Under paragraph (b)(4)(viii)(*d*) of this section, the $16,000 of taxes is allocated to the single CFTE category.

Therefore, the $16,000 of country X taxes is related to the $40,000 of net income in the single CFTE category that is allocated to A. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the country X taxes in proportion to the distributive share of income to which the taxes relate, AB satisfies the requirement of paragraph (b)(4)(viii) of this section, and the allocation of the country X taxes is deemed to be in accordance with the partners' interests in the partnership.

Example 28.

(i) B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of country X. B and C each contribute 50 percent of the capital of BC. B and C are wholly-owned subsidiaries of A, a domestic corporation. Substantially all of BC's income would not be subpart F income if earned directly by C. The BC partnership agreement provides that, for the first fifteen years, BC's gross income will be allocated 10 percent to B and 90 percent to C, and BC's deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement also provides that, after the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and BC's deductions and losses will be allocated 10 percent to B and 90 percent to C.

(ii) Apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other sections. See paragraph (b)(1)(iii) of this section. For example, BC's allocations of gross income, deductions, and losses may be evaluated and reallocated (or not respected), as appropriate, if it is determined that the allocations result in the evasion of tax or do not clearly reflect income under section 482.

Example 29.

PRS is a partnership with three equal partners, A, B, and C. A is a corporation that is a member of a consolidated group within the meaning of § 1.1502-1(h). B is a subchapter S corporation that is wholly owned by D, an individual. C is a partnership with two partners, E, an individual, and F, a corporation that is a member of a consolidated group within the meaning of § 1.1502-1(h). For purposes of paragraph (b)(2)(iii) of this section, in determining the after-tax economic benefit or detriment of an allocation to A, the tax consequences that result from the interaction of the allocation to A with the tax attributes of the consolidated group of which A is a member must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to B, the tax consequences that result from the interaction of the allocation with the tax attributes of D must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to C, the tax consequences that result from the interaction of the allocation with the tax attributes of E and the consolidated group of which F is a member must be taken into account.

Example 30.

(i) A, a controlled foreign corporation, and B, a foreign corporation that is not a controlled foreign corporation, form AB, a partnership organized under the laws of country X. The partnership agreement contains the provisions necessary to comply with the economic effect safe harbor of paragraph (b)(2)(ii)(*b*) of this section. A is wholly-owned by C, a domestic corporation that is not a member of a consolidated group within the meaning of § 1.1502-1(h). B is wholly owned by an individual who is a citizen and resident of country X and is not related to A. Neither A, B, nor AB, is engaged in a trade or business in the United States. A and B each contribute 50 percent of the capital of AB. There is a strong likelihood that in each of the next several years AB will realize equal amounts of gross income that would constitute subpart F income if allocated to A, and gross income that would not constitute subpart F income if allocated to A ("non-subpart F income"). A and B agree to share bottom-line net income from AB equally; however, rather than share all items of gross income equally, A and B agree that B will be allocated all of AB's subpart F income to the extent of its 50 percent share of bottom-line net income. In year 1, AB earns $60x of income, $30x of which is subpart F income and is allocated to B, and $30x of which is non-subpart F income and is allocated to A.

(ii) Although neither A nor B is subject to U.S. tax with respect to its distributive share of the income of AB, under paragraph (b)(2)(iii)(*d*) of this section, the tax attributes of C must be taken into account with respect to A for purposes of applying the tests described in paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section. The allocations in year 1 have economic effect. However, the economic effect of the allocations is not substantial under the test described in paragraph (b)(2)(iii)(*b*) of this section because there was a strong likelihood, at the time the allocations became part of the AB partnership agreement, that the net increases and decreases to A's and B's capital accounts in year 1 would not differ substantially when compared to the net increases and decreases to A's and B's capital accounts for year 1 if the allocations were not contained in the partnership agreement, and the total tax liability from the income earned by AB in year 1 (taking into account the tax attributes of the allocations to C) would be reduced as a result of such allocations. Under paragraph (b)(3) of this section, the subpart F income and non-subpart F income earned by AB in year 1 must each be reallocated 50 percent to A and 50 percent to B.

Example 31.

(i) In Year 1, A and B each contribute cash of $9,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a nondepreciable property, Property A, for $18,000. Later in Year 1, at a time when Property A is valued at $20,000, LLC issues an option to C. The option allows C to buy 100 units in LLC for an exercise price of $15,000 in Year 2. C pays $1,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that C's option is a noncompensatory option under § 1.721-2(f), and that C is not treated as a partner with respect to the option. Under paragraph (b)(2)(iv)(*f*)(*5*)(*iv*) of this section, LLC revalues its property in connection with the issuance of the option. The $2,000 unrealized gain in Property A is allocated equally to A and B under the LLC agreement. In Year 2, C exercises the option, contributing the $15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $35,000.

	Basis	**Value**
Year 1 After Issuance of the Option		
Assets:		
Cash Premium	$1,000	$1,000
Property A	18,000	20,000
Total	19,000	21,000
Liabilities and Capital:		
Cash Premium	1,000	1,000
A	9,000	10,000
B	9,000	10,000
Total	19,000	21,000
Year 2 After Exercise of the Option		
Assets:		
Property A Cash	18,000	35,000
Premium	1,000	1,000
Exercise Price	15,000	15,000

	Basis	Value
Total	34,000	51,000
Liabilities and Capital:		
A	9,000	17,000
B	9,000	17,000
C	16,000	17,000
Total	34,000	51,000

(ii) In lieu of revaluing LLC's property under paragraph (b)(2)(iv)(*f*) of this section immediately before the option is exercised, under paragraph (b)(2)(iv)(*s*)(*1*) of this section LLC must revalue its property under the principles of paragraph (b)(2)(iv)(*f*) of this section immediately after the exercise of the option. Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, C's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, C is entitled to LLC capital corresponding to 100 units of LLC (1⁄3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are cash of $16,000 ($1,000 premium and $15,000 exercise price contributed by C) and Property A, which has a value of $35,000. Thus, the total value of LLC's property is $51,000. C is entitled to LLC capital equal to 1⁄3 of this value, or $17,000. As C is entitled to $1,000 more LLC capital than C's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(iii) Under paragraph (b)(2)(iv)(*s*)(*2*) of this section, LLC must increase C's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section. The unrealized gain in LLC's property (Property A) which has not been reflected in the capital accounts previously is $15,000 ($35,000 value less $20,000 book value). Under paragraph (b)(2)(iv)(*s*)(*2*) of this section, the first $1,000 of this gain must be allocated to C, and the remaining $14,000 of this gain is allocated equally to A and B in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases C's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The $17,000 of unrealized booked gain in Property A ($35,000 value less $18,000 basis) is shared $8,000 to each A and B, and $1,000 to C. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$9,000	$10,000	$9,000	$10,000	$16,000	$16,000
Revaluation amount	0	7,000	0	7,000	0	1,000
Capital account after revaluation	9,000	17,000	9,000	17,000	16,000	17,000

Example 32.

(i) Assume the same facts as in *Example 31,* except that, in Year 2, before the exercise of the option, LLC sells Property A for $40,000, recognizing gain of $22,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 2. With the proceeds ($40,000), LLC purchases Property B, a nondepreciable property. Also assume that C exercises the noncompensatory option at the beginning of Year 3 and that, at the time C exercises the option, the value of Property B is $41,000. In Year 3, LLC has gross income of $3,000 and deductions of $1,500.

	Basis	Value
Year 2 After Purchase of Property B		
Assets:		

	Basis	Value
Cash Premium	$1,000	$1,000
Property B	40,000	40,000
Total	41,000	41,000
Liabilities and Capital:		
Cash Premium	1,000	1,000
A	20,000	20,000
B	20,000	20,000
Total	41,000	41,000
Year 3 After Exercise of the Option		
Assets:		
Property B	40,000	41,000
Cash	16,000	16,000
Total	56,000	57,000
Liabilities and Capital:		
A	20,000	19,000
B	20,000	19,000
C	16,000	19,000
Total	56,000	57,000

(ii) Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, C's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, C is entitled to LLC capital corresponding to 100 units of LLC (1⁄3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are $16,000 cash ($1,000 option premium and $15,000 exercise price contributed by C) and Property B, which has a value of $41,000. Thus, the total value of LLC's property is $57,000. C is entitled to LLC capital equal to 1⁄3 of this amount, or $19,000. As C is entitled to $3,000 more LLC capital than C's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(iii) In lieu of revaluing LLC's property under paragraph (b)(2)(iv)(*f*) of this section immediately before the option is exercised, under paragraph (b)(2)(iv)(*s*)(*1*) of this section LLC must revalue its property under the principles of paragraph (b)(2)(iv)(*f*) of this section immediately after the exercise of the option. Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase C's capital account from $16,000 to $19,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating all $1,000 of unrealized gain from the revaluation to C under paragraph (b)(2)(iv)(*s*)(*2*). This brings C's capital account to $17,000.

(iv) Next, under paragraph (b)(2)(iv)(*s*)(*3*) of this section, LLC must reallocate $2,000 of capital from the existing partners (A and B) to C to bring C's capital account to $19,000 (the capital account reallocation). As A and B shared equally in all items from Property A, whose sale gave rise to the need for the capital account reallocation, each member's capital account is reduced by 1⁄2 of the $2,000 reduction ($1,000).

(v) Under paragraph (b)(2)(iv)(*s*)(*4*) of this section, beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 3, LLC has gross income of $3,000 and deductions of $1,500. Under paragraph (b)(4)(x)(*c*), LLC must allocate the book gross income of $3,000 equally among A, B, and C, but for tax purposes, however, LLC must allocate all of its gross income ($3,000) to C. LLC's book and tax deductions ($1,500) will then be allocated equally among A, B, and C. The $1,000 unrealized booked gain in Property B has been allocated entirely to C. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from Property B must be allocated in accordance with section 704(c) principles.

	A		B		C	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account after exercise	$20,000	$20,000	$20,000	$20,000	$16,000	$16,000
Revaluation	0	0	0	0	0	1,000
Capital account after revaluation	20,000	20,000	20,000	20,000	16,000	17,000
Capital account reallocation	0	(1,000)	0	(1,000)	0	2,000
Capital account after capital account reallocation	20,000	19,000	20,000	19,000	16,000	19,000
Income allocation (Yr. 3)	0	1,000	0	1,000	3,000	1,000
Deduction allocation (Yr. 3)	(500)	(500)	(500)	(500)	(500)	(500)
Capital account at end of year 3	19,500	19,500	19,500	19,500	18,500	19,500

Example 33.

(i) In Year 1, D and E each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two nondepreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to F. The option allows F to buy 100 units in LLC for an exercise price of $15,000 in Year 2. F pays $2,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that F's option is a noncompensatory option under § 1.721-2(f), and that F is not treated as a partner with respect to the option.

	Basis	**Value**
End of Year 1		
Assets:		
Cash		
Premium	$2,000	$2,000
Property A	10,000	10,000
Property B	10,000	10,000
Total	22,000	22,000
Liabilities and Capital:		
Cash		
Premium	2,000	2,000
D	10,000	10,000
E	10,000	10,000
Total	22,000	22,000

(ii) In year 2, prior to the exercise of F's option, G contributes $18,000 to LLC for 100 units in LLC. At the time of G's contribution, Property A has a value of $32,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of F's option is $3,000. In year 2, LLC has no item of income, gain, loss, deduction, or credit.

(iii) Upon G's admission to the partnership, the capital accounts of D and E (which were $10,000 each prior to G's admission) are, in accordance with paragraph (b)(2)(iv)(*f*) of this section, adjusted upward to reflect their shares of the unrealized appreciation in the partnership's property. Property A has $22,000 of unrealized gain and Property B has $5,000 of unrealized loss. Under paragraph (b)(2)(iv)(*f*)(*1*) of this section, the adjustments must be based on the fair market value of LLC property (taking section 7701(g) into account) on the date of the adjustment, as determined under paragraph (b)(2)(iv)(*h*) of this section. The fair market value of partnership property must be reduced by the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by F to acquire the option ($3,000 −$2,000 = $1,000) (under paragraph (b)(2)(iv)(*h*)(*2*) of this section), but only to the extent of the unrealized appreciation in LLC property that has not been reflected in the capital accounts previously ($22,000). This $1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation not reflected in the capital accounts previously. Therefore, the book value of Property A is $31,000. Accordingly, the revaluation adjustments must reflect only $16,000 of the net appreciation in LLC's property ($21,000 of unrealized gain in Property A and $5,000 of unrealized loss in Property B). Thus, D's and E's capital accounts (which were $10,000 each prior to G's admission) must be adjusted upward (by $8,000) to $18,000 each. The $21,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between D and E in accordance with section 704(c) principles.

	Basis	**Value**	**Option adjustment**	**704(b) Book**
Assets:				
Property A	$10,000	$32,000	($1,000)	$31,000
Property B	10,000	5,000	0	5,000
Cash	2,000	2,000	0	2,000
Subtotal	22,000	39,000	(1,000)	38,000
Cash Contributed by G	18,000	18,000	0	18,000
Total	40,000	57,000	(1,000)	56,000

	Tax	**Value**	**704(b) Book**
Liabilities and Capital:			
Cash Premium (option value)	$ 2,000	$ 3,000	$ 2,000
D	10,000	18,000	18,000
E	10,000	18,000	18,000
G	18,000	18,000	18,000
Total	40,000	57,000	56,000

(iv) In year 2, after the admission of G, when Property A still has a value of $32,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, F exercises the option. On the exercise of the option, F's capital account is credited with the amount paid for the option ($2,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, F is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC's capital). Immediately after the exercise of the option, LLC's properties are worth $72,000 ($15,000 contributed by F, plus the value of LLC property prior to the exercise of the option, $57,000). F is entitled to LLC capital equal to 1/4 of this value, or $18,000. As F is entitled to $1,000 more LLC capital than F's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(v) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase F's capital account from $17,000 to $18,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section and allocating the first $1,000 of unrealized gain to F. The total unrealized gain which has not been reflected in the capital accounts previously is $1,000 (the difference between the actual value of Property A, $32,000, and the book value of Property A, $31,000). The entire $1,000 of book gain is allocated to F under paragraph (b)(2)(iv)(*s*)(*2*) of this section. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases F's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The ($5,000) of unrealized booked loss in Property B has been allocated ($2,500) to each D and E, and the $22,000 of unrealized booked gain in Property A has been allocated $10,500 to each D and E, and $1,000 to F. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from Properties A and B must be allocated in accordance with section 704(c) principles.

	D		**E**		**G**		**F**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account after admission of G	$10,000	$18,000	$10,000	$18,000	$18,000	$18,000	0	0
Capital account after exercise of F's option	10,000	18,000	10,000	18,000	18,000	18,000	17,000	17,000
Revaluation	0	0	0	0	0	0	0	1,000
Capital account after revaluation	10,000	18,000	10,000	18,000	18,000	18,000	17,000	18,000

Example 34.

(i) On the first day of Year 1, H, I, and J form LLC, a limited liability company classified as a partnership for Federal tax purposes. H and I each contribute $10,000 cash to LLC for 100 units of common interest in LLC. J contributes $10,000 cash for a convertible preferred interest in LLC. J's convertible preferred interest entitles J to receive an annual allocation and distribution of cumulative LLC net profits in an amount equal to 10 percent of J's unreturned capital. J's convertible preferred interest also entitles J to convert, in Year 3, J's preferred interest into 100 units of common interest. If J converts, J has the right to the same share of LLC capital as J would have had if J had held the 100 units of common interest since the formation of LLC. Under the LLC agreement, each unit of common interest has an equal right to share in any LLC net profits that remain after payment of the preferred return. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that J's right to convert the preferred interest into a common interest qualifies as a noncompensatory option under § 1.721-2(f), and that, prior to the exercise of the conversion right, the conversion right is not treated as a partnership interest.

(ii) LLC uses the $30,000 to purchase Property Z, a property that is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of $2,500, comprised of $4,500 of gross income and $2,000 of depreciation. It allocates $1,000 of net income to J and distributes $1,000 to J in each year. LLC allocates the remaining $1,500 of net income equally to H and I in each year but makes no distributions to H and I.

	H		**I**		**J**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account upon formation	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Allocation of income Years 1 and 2	1,500	1,500	1,500	1,500	2,000	2,000
Distributions Years 1 and 2	0	0	0	0	(2,000)	(2,000)
Capital account at end of Year 2	11,500	11,500	11,500	11,500	10,000	10,000

(iii) At the beginning of Year 3, when Property Z has a value of $38,000 and a basis of $26,000 ($30,000 original basis less $4,000 of depreciation) and LLC has accumulated undistributed cash of $7,000 ($9,000 gross receipts less $2,000 distributions), J converts J's preferred interest into a common interest. Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, J's capital account after the conversion equals J's capital account before the conversion, $10,000. On the conversion of the preferred interest, however, J is entitled to LLC capital corresponding to 100 units of common interest in LLC (1⁄3 of LLC's capital). At the time of the conversion, the total value of LLC property is $45,000. J is entitled to LLC capital equal to 1⁄3 of this value, or $15,000. As J is entitled to $5,000 more LLC capital than J's capital account immediately after the conversion, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

	Basis	**Value**
Assets:		
Property Z	$26,000	$38,000
Undistributed Income	7,000	7,000
Total	33,000	45,000
Liabilities and Capital:		
H	11,500	15,000
I	11,500	15,000
J	10,500	15,000
Total	33,000	45,000

(iv) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase J's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the first $5,000 of unrealized gain from that revaluation to J. The unrealized gain in Property Z is $12,000 ($38,000 value less $26,000 basis). The first $5,000 of this unrealized gain must be allocated to J under paragraph (b)(2)(iv)(*s*)(*2*) of this section. The remaining $7,000 of the unrealized gain must be allocated equally to H and I in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases J's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The $12,000 of unrealized booked gain in Property Z has been allocated $3,500 to each H and I, and $5,000 to J. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	H		**I**		**J**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Capital account prior to conversion	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000
Revaluation on conversion	0	3,500	0	3,500	0	5,000
Capital account after conversion	11,500	15,000	11,500	15,000	10,000	15,000

Example 35.

(i) On the first day of Year 1, K and L each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Immediately after its formation, LLC borrows $10,000 from M. Under the terms of the debt instrument, interest of $1,000 is unconditionally payable at the end of each year and the $10,000 stated principal is repayable in five years. Throughout the term of the indebtedness, M has the right to convert the debt instrument into 100 units in LLC. If M converts, M has the right to the same share of LLC capital as M would have had if M had held 100 units in LLC since the formation of LLC. Under the LLC agreement, each unit participates equally in the profits and losses of LLC and has an equal right to share in LLC capital. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that M's right to convert the debt into an interest in LLC qualifies as a noncompensatory option under § 1.721-2(f), and that, prior to the exercise of the conversion right, M is not treated as a partner with respect to the convertible debt.

(ii) LLC uses the $30,000 to purchase Property D, property that is depreciable on a straight-line basis over 15 years. In each of Years 1, 2, and 3, LLC has net income of $2,000, comprised of $5,000 of gross income, $2,000 of depreciation, and interest expense (representing payments of interest on the loan from M) of $1,000. LLC allocates this income equally to K and L but makes no distributions to either K or L.

	K		**L**		**M**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Initial capital account	$10,000	$10,000	$10,000	$10,000	0	0
Year 1 net income	1,000	1,000	1,000	1,000	0	0
Year 2 net income	1,000	1,000	1,000	1,000	0	0
Year 3 net income	1,000	1,000	1,000	1,000	0	0
Year 4 initial capital account	13,000	13,000	13,000	13,000	0	0

(iii) At the beginning of Year 4, at a time when property D, LLC's only asset, has a value of $33,000 and basis of $24,000 ($30,000 original basis less $6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of $12,000 ($15,000 gross income less $3,000 of interest payments) in LLC, M converts the debt into a 1⁄3 interest in LLC. Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, M's capital account after the conversion is the adjusted issue price of the debt immediately before M's conversion of the debt, $10,000, plus any accrued but unpaid qualified stated interest on the debt, $0. On the conversion of the debt, however, M is entitled to receive LLC capital corresponding to 100 units of LLC (1⁄3 of LLC's capital). At the time of the conversion, the total value of LLC's property is $45,000. M is entitled to LLC capital equal to 1⁄3 of this value, or $15,000. As M is entitled to $5,000 more LLC capital than M's capital contribution to LLC ($10,000), the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

	Basis	**Value**
Assets:		
Property D	$24,000	$33,000
Cash	$12,000	$12,000
Total	$36,000	$45,000
Liabilities and Capital:		
K	$13,000	$15,000
L	$13,000	$15,000
M	$10,000	$15,000
	$36,000	$45,000

(iv) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase M's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the first $5,000 of unrealized gain from that revaluation to M. The unrealized gain in Property D is $9,000 ($33,000 value less $24,000 basis). The first $5,000 of this unrealized gain must be allocated to M under paragraph (b)(2)(iv)(*s*)(*2*) of this section, and the remaining $4,000 of the unrealized gain must be allocated equally to K and L in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases M's capital account to the amount agreed upon by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The $9,000 unrealized booked gain in property D has been allocated $2,000 to each K and L, and $5,000 to M. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	K		L		M	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Year 4 capital account prior to exercise	$13,000	$13,000	$13,000	$13,000	0	0
Capital account after exercise	13,000	13,000	13,000	13,000	10,000	10,000
Revaluation	0	2,000	0	2,000	0	5,000
Capital account after revaluation	13,000	15,000	13,000	15,000	10,000	15,000

Example 36.

[Reserved]. For further guidance, see § 1.704-1T(b)(5) *Example 36.*

Example 37.

[Reserved]. For further guidance, see § 1.704-1T(b)(5) *Example 37.*

(6) *Examples.*

(i) *Example 1.*

(*a*) A contributes $750,000 and B contributes $250,000 to form AB, a country X eligible entity (as defined in § 301.7701-3(a) of this chapter) treated as a partnership for U.S. Federal income tax purposes. AB operates business M in country X. Country X imposes a 20 percent tax on the net income from business M, which tax is a CFTE. In 2016, AB earns $300,000 of gross income, has deductible expenses of $100,000, and pays or accrues $40,000 of country X tax. Pursuant to the partnership agreement, the first $100,000 of gross income each year is specially allocated to A as a preferred return on excess capital contributed by A. All remaining partnership items, including CFTEs, are split evenly between A and B (50 percent each). The gross income allocation is not deductible in determining AB's taxable income under country X law. Assume that allocations of all items other than CFTEs are valid.

(*b*) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the net income in the single CFTE category is $200,000. The $40,000 of taxes is allocated to the single CFTE category and, thus, is related to the $200,000 of net income in the single CFTE category. In 2016, AB's partnership agreement results in an allocation of $150,000 or 75 percent of the net income to A ($100,000 attributable to the gross income allocation plus $50,000 of the remaining $100,000 of net income) and $50,000 or 25 percent of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the $100,000 gross income allocation. Therefore, AB allocates the country X taxes 50 percent to A ($20,000) and 50 percent to B ($20,000). AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section because they are not in proportion to the allocations of the CFTE category shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interests in the partnership. Assuming that the partners do not reasonably expect to claim a deduction for the CFTEs in determining their U.S. Federal income tax liabilities, a reallocation of the CFTEs under paragraph (b)(3) of this section would be 75 percent to A ($30,000) and 25 percent to B ($10,000). If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure that the tax consequences of the partnership's allocations are consistent with their contemplated economic arrangement over the term of the partnership.

(*c*) The facts are the same as in paragraph (b)(6)(i)(*a*) of this section, except that country X allows a deduction for the $100,000 allocation of gross income and, as a result, AB pays or accrues only $20,000 of foreign tax. Under paragraph (b)(4)(viii)(*c*)(*4*)(*ii*) of this section, the net income in the single CFTE category is $100,000, determined by reducing the net income in the CFTE category by the $100,000 of gross income that is allocated to A and for which country X allows a deduction in determining AB's taxable income. Pursuant to the partnership agreement, AB allocates the country X tax 50 percent to A ($10,000) and 50 percent to B ($10,000). This allocation is in proportion to the partners' CFTE category shares of the $100,000 net income. Accordingly, AB's allocations of country X taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii)(*a*) of this section.

(*d*) The facts are the same as in paragraph (b)(6)(i)(*c*) of this section, except that, in addition to $20,000 of country X tax, AB is subject to $30,000 of country Y withholding tax with respect to the $300,000 of gross income that it earns in 2016. Country Y does not allow any deductions for purposes of determining the withholding tax. As described in paragraph (b)(6)(i)(*b*) of this section, there is a single CFTE category with respect to AB's net income. Both the $20,000 of country X tax and the $30,000 of country Y withholding tax relate to that income and are therefore allocated to the single CFTE category. Under paragraph (b)(4)(viii)(*c*)(*4*)(*iii*) of this section, however, net income in a CFTE category is reduced by the amount of an allocation for which a deduction is allowed in determining a foreign taxable base, but only for purposes of applying paragraph (b)(4)(viii)(*a*) of this section to allocations of CFTEs that are attributable to that foreign tax. Accordingly, because the $100,000 allocation of gross income is deductible for country X tax purposes but not for country Y tax purposes, the allocations of the CFTEs attributable to country X tax and country Y tax are analyzed separately. For purposes of applying paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of the CFTEs attributable to the $20,000 tax imposed by country X, the analysis described in paragraph (b)(6)(i)(*c*) of this section applies. For purposes of applying paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of the CFTEs attributable to the $30,000 tax imposed by country Y, which did not allow a deduction for the $100,000 gross income allocation, the net income in the single CFTE category is $200,000. Pursuant to the partnership agreement, AB allocates the country Y tax 50 percent to A ($15,000) and 50 percent to B ($15,000). These allocations are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section because they are not in proportion to the partners' CFTE category shares of the $200,000 of net income in the category, which is allocated 75 percent to A and 25 percent to B under the partnership agreement. Accordingly, the country Y taxes will be reallocated according to the partners' interests in the partnership as described in paragraph (b)(6)(i)(*b*) of this section.

(*e*) If, rather than being a preferential gross income allocation, the $100,000 was a guaranteed payment to A within the meaning of section 707(c), the amount of net income in the single CFTE category of AB for purposes of applying paragraph (b)(4)(viii)(*a*)(*1*) of this section to allocations of CFTEs would be the same as in the fact patterns described in paragraphs (b)(6)(i)(*b*), (*c*), and (*d*) of this section. See paragraph (b)(4)(viii)(*c*)(*4*)(*ii*) of this section.

(ii) *Example 2.*

(*a*) A, B, and C form ABC, an eligible entity (as defined in § 301.7701-3(a) of this chapter) treated as a partnership for U.S. Federal income tax purposes. ABC owns three entities, DEX, DEY, and DEZ, which are organized in, and treated as corporations under the laws of, countries X, Y, and Z, respectively, and as disregarded entities for U.S. Federal income tax purposes. DEX operates business X in country X, DEY operates business Y in country Y, and DEZ operates business Z in country Z. Businesses X, Y, and Z relate to the licensing and sublicensing of intellectual property owned by DEZ. During 2016, DEX earns $100,000 of royalty income from unrelated payors on which it pays no withholding taxes. Country X imposes a 30 percent tax on DEX's net income. DEX makes royalty payments of $90,000 during 2016 to DEY that are deductible by DEX for country X purposes and subject to a 10 percent withholding tax imposed by country X. DEY earns no other income in 2016. Country Y does not impose income or withholding taxes. DEY makes royalty payments of $80,000 during 2016 to DEZ. DEZ earns no other income in 2016. Country Z does not impose income or withholding taxes. The royalty payments from DEX to DEY and from DEY to DEZ are disregarded for U.S. Federal income tax purposes.

(*b*) As a result of these payments, DEX has taxable income of $10,000 for country X purposes on which $3,000 of taxes are imposed, and DEY has $90,000 of income for country X withholding tax purposes on which $9,000 of withholding taxes are imposed. Pursuant to the partnership agreement, all partnership items from business X, excluding CFTEs paid or accrued by business X, are allocated 80 percent to A and 10 percent each to B and C. All partnership items from business Y, excluding CFTEs paid or accrued by business Y, are allocated 80 percent to B and 10 percent each to A and C. All partnership items from business Z, excluding CFTEs paid or accrued by business Z, are allocated 80 percent to C and 10 percent each to A and B. Because only business X has items that are regarded for U.S. Federal income tax purposes (the $100,000 of royalty income), only business X has partnership items. Accordingly A is allocated 80 percent of the income from business X ($80,000) and B and C are each allocated 10 percent of the income from business X ($10,000 each). There are no partnership items of income from business Y or Z to allocate.

(*c*) Because the partnership agreement provides for different allocations of partnership net income attributable to businesses X, Y, and Z, the net income attributable to each of businesses X, Y, and Z is income in separate CFTE categories. See paragraph (b)(4)(viii)(*c*)(*2*) of this section. Under paragraph (b)(4)(viii)(*c*)(*3*)(*iv*) of this section, an item of gross income that is recognized for U.S. Federal income tax purposes is assigned to the activity that generated the item, and disregarded inter-branch payments are not taken into account in determining net income attributable to an activity. Consequently, all $100,000 of ABC's income is attributable to the business X activity for U.S. Federal income tax purposes, and no net income is in the business Y or Z CFTE category. Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $3,000 of country X taxes imposed on DEX is allocated to the business X CFTE category. The additional $9,000 of country X withholding tax imposed with respect to the inter-branch payment to DEY is also allocated to the business X CFTE category because for U.S. Federal income tax purposes the related $90,000 of income on which the country X withholding tax is imposed is in the business X CFTE category. Therefore, $12,000 of taxes ($3,000 of country X income taxes and $9,000 of the country X withholding taxes) is related to the $100,000 of net income in the business X CFTE. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. The allocations of country X taxes will be in proportion to the CFTE category shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 80 percent to A and 10 percent each to B and C.

(iii) *Example 3.*

(*a*) Assume that the facts are the same as in paragraph (b)(5)(ii)(*a*) of this section, except that in order to reflect the $90,000 payment from DEX to DEY and the $80,000 payment from DEY to DEZ, the partnership agreement treats only $10,000 of the gross income as attributable to the business X activity, which the partnership agreement allocates 80 percent to A and 10 percent each to B and C. Of the remaining $90,000 of gross income, the partnership agreement treats $10,000 of the gross income as attributable to the business Y activity, which the partnership agreement allocates 80 percent to B and 10 percent each to A and C; and the partnership agreement treats $80,000 of the gross income as attributable to the business Z activity, which the partnership agreement allocates 80 percent to C and 10 percent each to A and B. In addition, the partnership agreement allocates the country X taxes among A, B, and C in accordance with which disregarded entity is considered to have paid the taxes for country X purposes. The partnership agreement allocates the $3,000 of country X income taxes 80 percent to A and 10 percent to each of B and C, and allocates the $9,000 of country X withholding taxes 80 percent to B and 10 percent to each of A and C. Thus, ABC allocates the country X taxes $3,300 to A (80 percent of $3,000 plus 10 percent of $9,000), $7,500 to B (10 percent of $3,000 plus 80 percent of $9,000), and $1,200 to C (10 percent of $3,000 plus 10 percent of $9,000).

(*b*) In order to prevent separating the CFTEs from the related foreign income, the special allocations of the $10,000 and $80,000 treated under the partnership agreement as attributable to the business Y and the business Z activities, respectively, which do not follow the allocation ratios that otherwise apply under the partnership agreement to items of income in the business X activity, are treated as divisible parts of the business X activity and, therefore, as separate activities. See paragraph (b)(4)(viii)(*c*)(*2*)(*iii*) of this section. Because the divisible part of the business X activity attributable to the portion of the disregarded payment received by DEY and not paid on to DEZ ($10,000) and the net income from the business Y activity ($0) are both shared 80 percent to B and 10 percent each to A and C, that divisible part of the business X activity and the business Y activity are treated as a single CFTE category. Because the divisible part of the business X activity attributable to the disregarded payment paid to DEZ ($80,000) and the net income from the business Z activity ($0) are both shared 80 percent to C and 10 percent each to A and B, that divisible part of the business X activity and the business Z activity are also treated as a single CFTE category. See paragraph (b)(4)(viii)(*c*)(*2*)(*i*) of this section. Accordingly, $10,000 of net income attributable to business X is in the business X CFTE category, $10,000 of net income of business X attributable to the net disregarded payments of DEY is in the business Y CFTE category, and $80,000 of net income of business X attributable to the disregarded payment to DEZ is in the business Z CFTE category.

(*c*) Under paragraph (b)(4)(viii)(*d*)(*1*) of this section, the $3,000 of country X tax imposed on DEX's income is allocated to the business X CFTE category. Because the $90,000 on which the country X withholding tax is imposed is split between the business Y CFTE category and the business Z CFTE category, those withholding taxes are allocated on a pro rata basis, $1,000 [$9,000 x ($10,000/$90,000)] to the business Y CFTE category and $8,000 [$9,000 x ($80,000/$90,000)] to the business Z CFTE category. See paragraph (b)(4)(viii)(*d*)(*1*) of this section. To satisfy the safe harbor of paragraph (b)(4)(viii) of this section, the $3,000 of country X taxes allocated to the business X CFTE category must be allocated in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80 percent to A and 10 percent each to B and C. The allocation of the $1,000 of country X withholding taxes allocated to the business Y CFTE category would be in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80 percent to B and 10 percent each to A and C. The allocation of the $8,000 of country X withholding taxes allocated to the business Z CFTE category would be in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80 percent to C and 10 percent each to A and B. Thus, to satisfy the safe harbor, ABC must allocate the country X taxes $3,300 to A (80 percent of $3,000 plus 10 percent of $1,000 plus 10 percent of $8,000), $1,900 to B (10 percent of $3,000 plus 80 percent of $1,000 plus 10 percent of $8,000), and $6,800 to C (10 percent of $3,000 plus 10 percent of $1,000 plus 80 percent of $8,000).

(*d*) ABC's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section because they are not in proportion to the partners' CFTE category shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interests in the partnership.

(c) *Contributed property; cross-reference.* See § 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 § 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 §§ 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.

(f) *Applicability dates* -

(1) *In general.* Except as provided in paragraph (f)(2) of this section, paragraph (b)(2)(iv)(*f*)(*6*) of this section applies with respect to contributions occurring on or after January 18, 2017, and with respect to contributions that occurred before January 18, 2017 resulting from an entity classification election made under § 301.7701-3 of this chapter that was effective on or before January 18, 2017 but was filed on or after January 18, 2017.

(2) *Election to apply the provisions described in paragraph (f)(1) of this section retroactively.* Paragraph (b)(2)(iv)(*f*)(*6*) of this section may, by election, be applied with respect to a contribution that occurred on or after August 6, 2015 but before January 18, 2017, and with respect to a contribution that occurred before August 6, 2015 resulting from an entity classification election made under § 301.7701-3 of this chapter that was effective on or before August 6, 2015 but was filed on or after August 6, 2015. The election must have been made by applying paragraph (b)(2)(iv)(*f*)(*6*) of this section on a timely filed original return (including extensions) or an amended return filed no later than July 18, 2017.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.704-2 Allocations attributable to nonrecourse liabilities.

(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 § 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 § 1.752-1(a)(2) or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after June 24, 2003.

(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 § 1.1001-2, and a partner or related person (within the meaning of § 1.752-4(b)) bears the economic risk of loss under § 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)(iv) 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) 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 § 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 § 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 year of revaluation.* If the partners' capital accounts are increased pursuant to § 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 § 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 § 1.704-1(b)(2)(ii)(*b*) are satisfied (*i.e.,* capital accounts are maintained in accordance with § 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 § 1.704-1(b)(2)(ii)(*b*) or § 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, the 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 § 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 § 1.704-1(b)(4)(v)).

(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 § 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 nonrecourse debt into nonrecourse debt.* A partner's share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a recourse or partner nonrecourse liability becomes 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 § 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 § 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.

(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 recharacterization of nonrecourse partnership debt as partially or wholly recourse

debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of § 1.752-2) for the 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 a pro rata portion of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and income from the discharge of indebtedness relating to one or more partnership nonrecourse liabilities to which partnership property is subject, 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 (j)(2)(iii) of this section for more specific ordering rules.

(7) *Examples.* The following examples illustrate the provisions in § 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 90 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 in $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 distributed $50 each to reflect their ratio for sharing profits.

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

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 has $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 their 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.

(j) *Ordering rules.* For purposes of this section, the following ordering rules apply to partnership items. Notwithstanding any other provision in this section and § 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, a pro rata portion of gain from the disposition of property subject to partnership nonrecourse liabilities and discharge of indebtedness income relating to partnership nonrecourse liabilities to which property is subject;

(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, a pro rata portion of gain from the disposition of property subject to partner nonrecourse debt and discharge of indebtedness income relating to partner nonrecourse debt to which property is subject.

(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.

(m) *Examples.* The principles of this section are illustrated by the following examples:

§ 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 § 1.704-3(d). Paragraph (e) of this section contains special rules and exceptions. The principles of this paragraph (a)(1), together with the methods described in paragraphs (b), (c) and (d) of this section, apply only to contributions of property that are otherwise respected. See for example § 1.701-2. Accordingly, even though a partnership's allocation method may be described in the literal language of paragraphs (b), (c) or (d) of this section, based on the particular facts and circumstances, the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of subchapter K. One factor that may be considered by the Commissioner is the use of the remedial allocation method by related partners in which allocations of remedial items of income, gain, loss or deduction are made to one partner and the allocations of offsetting remedial items are made to a related partner.

(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 § 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 § 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 § 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 § 1.704-1(b)(2)(iv)(*d*), and is appropriately adjusted thereafter (e.g., for book cost recovery under §§ 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 § 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 § 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. *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.

(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 § 1.704-1(b)(2)(iv)(*f*) or 1.704-1(b)(2)(iv)(*s*) (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 § 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) *Transfer 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. This rule does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which paragraph (e)(1) of § 1.752-7 applies. See § 1.752-7(c)(1).

(8) *Special rules* -

(i) *Disposition in a nonrecognition transaction.* If a partnership disposes of section 704(c) property in a nonrecognition transaction, 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.

(ii) *Disposition in an installment sale.* If a partnership disposes of section 704(c) property in an installment sale as defined in section 453(b), the installment obligation received by the partnership is treated as the section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property.

(iii) *Contributed contracts.* If a partner contributes to a partnership a contract that is section 704(c) property, and the partnership subsequently acquires property pursuant to the contract in a transaction in which less than all of the gain or loss is recognized, then the acquired property is treated as the section 704(c) property with the same amount of built-in gain or loss as the contract (with appropriate adjustments for any gain or loss recognized on the acquisition). For this purpose, the term contract includes, but is not limited to, options, forward contracts, and futures contracts. The allocation method for the acquired property must be consistent with the allocation method chosen for the contributed contract.

(iv) *Capitalized amounts.* To the extent that a partnership properly capitalizes all or a portion of an item as described in paragraph (a)(12) of this section, then the item or items to which such cost is properly capitalized is treated as section 704(c) property with the same amount of built-in loss as corresponds to the amount capitalized.

(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 § 1.704-1(b)(2)(iv)(*q*) (relating to capital account adjustments where guidance is lacking).

(10) *Anti-abuse rule* -

(i) *In general.* 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. For purposes of this paragraph (a)(10), all references to the partners shall include both direct and indirect partners.

(ii) *Definition of indirect partner.* An *indirect partner* is any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation (as defined in section 957(a) or 953(c)), or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership, and any consolidated group of which the partner in the partnership is a member (within the meaning of § 1.1502-1(h)). An owner (whether directly or through tiers of entities) of a controlled foreign corporation is treated as an indirect partner only with respect to allocations of items of income, gain, loss, or deduction that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this sentence if such items were allocated to the controlled foreign corporation.

(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 §§ 1.1245-1(e)(2) and 1.1250-1(f).

(12) *§ 1.752-7 liabilities.* Except as otherwise provided in § 1.752-7, § 1.752-7 liabilities (within the meaning of § 1.752-7(b)(2)) are section 704(c) property (built-in loss property that at the time of contribution has a book value that differs from the contributing partner's adjusted tax basis) for purposes of applying the rules of this section. See § 1.752-7(c). To the extent that the built-in loss associated with the § 1.752-7 liability exceeds the cost of satisfying the § 1.752-7 liability (as defined in § 1.752-7(b)(3)), the excess creates a "ceiling rule" limitation, within the meaning of § 1.704-3(b)(1), subject to the methods of allocation set forth in § 1.704-3(b), (c) and (d).

(13) Rules for tiered section 721(c) partnerships -

(i) Revaluations. If a partnership revalues its property pursuant to § 1.704-1(b)(2)(iv)(*f*)(*6*) immediately before an interest in the partnership is contributed to another partnership, or if an upper-tier partnership owns an interest in a lower-tier partnership, and both the upper-tier partnership and the lower-tier partnership revalue partnership property pursuant to § 1.704-1(b)(2)(iv)(*f*)(*6*), the principles of paragraph (a)(9) of this section will apply to any reverse section 704(c) allocations made as a result of the revaluation.

(ii) *Basis-derivative items.* If a lower-tier partnership that is a section 721(c) partnership applies the gain deferral method, then, for purposes of applying this section, the upper-tier partnership must treat its distributive share of lower-tier partnership items of gain, loss, amortization, depreciation, or other cost recovery with respect to the lower-tier partnership's section 721(c) property as though they were items of gain, loss, amortization, depreciation, or other cost recovery with respect to the upper-tier partnership's interest in the lower-tier partnership. For purposes of this paragraph (a)(13)(ii), gain deferral method is defined in § 1.721(c)-1(b)(8), section 721(c) partnership is defined in § 1.721(c)-1(b)(14), and section 721(c) property is defined in § 1.721(c)-1(b)(15).

(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 § 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:

E		F	
Book	**Tax**	**Book**	**Tax**

E		F		
Book	**Tax**	**Book**	**Tax**	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	350	350	350	Sales income.
9,850	4,350	9,850	9,950	

(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:

E		F		
Book	**Tax**	**Book**	**Tax**	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	450	350	250	Sales income.
9,850	4,450	9,850	9,850	

(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:

E		F		
Book	**Tax**	**Book**	**Tax**	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	700	350	0	Sales income.
9,850	4,700	9,850	9,600	

(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:

G		H		
Book	**Tax**	**Book**	**Tax**	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<1,000>	<1,000>	<200>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,500	8,500	5,700	

(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:

G		H		
Book	**Tax**	**Book**	**Tax**	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<600>	<1,000>	<600>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,900	8,500	5,300	

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 § 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:

J		K		
Book	**Tax**	**Book**	**Tax**	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,000	4,000	4,000	Sales income.

J		K	
Book	**Tax**	**Book**	**Tax**
9,000	5,000	9,000	13,000

(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:

J		K		
Book	**Tax**	**Book**	**Tax**	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	8,000	4,000	0	Sales income.
9,000	9,000	9,000	9,000	

(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:

J		K		
Book	**Tax**	**Book**	**Tax**	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,400	4,000	3,600	Sales income.
9,000	5,400	9,000	12,600	

(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 § 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. However, the additional first year depreciation deduction under section 168(k) is not a permissible method for purposes of the preceding sentence and, if a partnership has acquired property in a taxable year for which the additional first year depreciation deduction under section 168(k) has been used of the same type as the contributed property, the portion of the contributed property's book basis that exceeds its adjusted tax basis must be recovered under a reasonable method. See § 1.168(k)-2(b)(3)(iv)(B).

(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.

(iii) *Special rules for a section 721(c) partnership and anti-churning property* -

(A) *In general.* Solely in the case of a gain deferral contribution of section 721(c) property that is a section 197(f)(9) intangible that was not an amortizable section 197 intangible in the hands of the contributor, the remedial allocation method is modified with respect to allocations to a related person to the U.S. transferor pursuant to paragraphs (d)(5)(iii)(B) through (F) of this section. For purposes of this paragraph (d)(5)(iii), gain deferral contribution is defined in § 1.721(c)-1(b)(7), related person is defined in § 1.721(c)-1(b)(12), section 721(c) partnership is defined in § 1.721(c)-1(b)(14), section 721(c) property is defined in § 1.721(c)-1(b)(15), and U.S. transferor is defined in § 1.721(c)-1(b)(18). For an example applying the rules of this paragraph (d)(5)(iii), see § 1.721(c)-7(b)(6) (*Example 6*).

(B) *Book basis recovery.* The section 721(c) partnership must amortize the portion of the partnership's book value in the section 197(f)(9) intangible that exceeds the adjusted basis in the property upon contribution using any recovery period and amortization method available to the partnership as if the property had been newly purchased by the partnership from an unrelated party.

(C) *Effect of ceiling rule limitations.* If the ceiling rule causes the book allocation of the item of amortization of a section 197(f)(9) intangible under paragraph (d)(5)(iii)(B) of this section by a section 721(c) partnership to a related person with respect to the U.S. transferor to differ from the tax allocation of the same item to the related person (a ceiling rule limited related person), the partnership must not create a remedial item of deduction to allocate to the related person but instead must increase the adjusted basis of the section 197(f)(9) intangible by an amount equal to the difference solely with respect to that related person. The partnership simultaneously must create an offsetting remedial item in an amount identical to the increase in adjusted tax basis of the section 197(f)(9) intangible and allocate it to the contributing partner.

(D) *Effect of basis adjustment* -

(*1*) *In general.* The basis adjustment described in paragraph (d)(5)(iii)(C) of this section constitutes an adjustment to the adjusted basis of a section 197(f)(9) intangible with respect to the ceiling rule limited related person only. No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating gain and loss, the ceiling rule limited related person will have a special basis for that section 197(f)(9) intangible. The adjustment to the basis of partnership property under this section has no effect on the partnership's computation of any item under section 703.

(*2*) *Computation of a partner's distributive share of partnership items.* The partnership first computes its items of gain or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the ceiling rule limited related person, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the ceiling rule limited related person's distributive share of the items of partnership gain or loss, in accordance with paragraph (d)(5)(iii)(D)(*3*) of this section, to reflect the effects of that person's basis adjustment under this section. These adjustments to that person's distributive shares must be reflected on Schedules K and K-1 of the partnership's return (Form 1065) (when otherwise required to be completed) and do not affect that person's capital account.

(*3*) *Effect of basis adjustment in determining items of income, gain, or loss.* The amount of a ceiling rule limited related person's gain or loss from the sale or exchange of a section 197(f)(9) intangible in which that person has a tax basis adjustment is equal to that person's share of the partnership's gain or loss from the sale of the asset (including any remedial allocations under this paragraph (d)), minus the amount of that person's tax basis adjustment for the section 197(f)(9) intangible.

(E) *Subsequent transfers* -

(*1*) *In general.* Except as provided in paragraph (d)(5)(iii)(E)(*2*) of this section, if a ceiling rule limited related person transfers all or part of its partnership interest, the portion of the basis adjustment for a section 197(f)(9) intangible attributable to the interest transferred is eliminated. The transferor of the partnership interest remains the ceiling rule limited related person with respect to any remaining basis adjustment for the section 197(f)(9) intangible.

(*2*) *Special rules for substituted basis transactions.* Paragraph (d)(5)(iii)(E)(*1*) of this section does not apply to the extent a ceiling rule limited related person transfers its partnership interest in a transaction in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the ceiling rule limited related person's basis in that interest. Instead, in such a case, the transferee succeeds to that portion of the transferor's basis adjustment for a section 197(f)(9) intangible attributable to the interest transferred. In such a case, the basis adjustment in a section 197(f)(9) intangible to which the transferee succeeds is taken into account for purposes of determining the transferee's share of the adjusted basis to the partnership of the partnership's property for purposes of §§ 1.743-1(b) and 1.755-1(b)(5). To the extent a transferee would be required to decrease the adjusted basis of a section 197(f)(9) intangible pursuant to §§ 1.743-1(b)(2) and 1.755-1(b)(5), the decrease first reduces the special basis adjustment described in paragraph (d)(5)(iii)(C) of this section, if any, to which the transferee succeeds.

(F) *Non-amortization of basis adjustment.* Neither the increase to the adjusted basis of a section 197(f)(9) intangible with respect to a ceiling rule limited related person nor the portion of the basis of any property that was determined by reference to such increase is subject to amortization, depreciation, or other cost recovery.

(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:

	L		M	
	Book	**Tax**	**Book**	**Tax**

	L		M	
	Book	**Tax**	**Book**	**Tax**
Initial contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	<3,200>	<800>	<3,200>	<3,200>
	$6,800	$3,200	$6,800	$6,800

(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 allotted $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:

	L		M	
	Book	**Tax**	**Book**	**Tax**
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
	$6,500	$3,200	$6,500	$6,800

(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:

	L		M	
	Book	**Tax**	**Book**	**Tax**
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
Remedial allocations		300		<300>
	$6,500	$3,500	$6,500	$6,500

(C) At the end of year 10, LM's capital accounts are as follows:

	L		M	
	Book	**Tax**	**Book**	**Tax**
End of year 5	$6,500	$3,500	$6,500	$6,500
Depreciation	<1,500>		<1,500>	
Remedial allocations		1,500		<1,500>
	$5,000	$5,000	$5,000	$5,000

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:

	N		**P**	
	Book	**Tax**	**Book**	**Tax**
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	
	$9,500	$9,000	$9,500	$10,000

(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:

	N		**P**	
	Book	**Tax**	**Book**	**Tax**
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	
Remedial allocations		500		<500>
	$9,500	$9,500	$9,500	$9,500

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:

	N		**P**	
	Book	**Tax**	**Book**	**Tax**
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
	$6,500	$4,000	$6,500	$9,000

(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:

	N		**P**	
	Book	**Tax**	**Book**	**Tax**
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
Remedial Allocations		2,500		<2,500>
	$6,500	$6,500	$6,500	$6,500

(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 § 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;

(C) With respect to any person who directly or indirectly holds an Applicable Partnership Interest, as defined in § 1.1061-1(a)(1), take into account the application of section 1061 with respect to such interest in an appropriate manner; and

(D) 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 § 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 § 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:

	Stock 1	**Stock 2**	**Stock 3**	**Stock 4**
Opening Balance	$100,000	$100,000	$100,000	
Day 2 Adjustment	2,000	5,000	(2,000)	
Total	$102,000	$105,000	$98,000	$152,500

			X
	Book	**Tax**	**Revaluation account**
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing Balance	$152,500	$150,000	$2,500

			Y
	Book	**Tax**	**Revaluation account**
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing balance	$152,500	$150,000	$2,500

			Z
	Book	**Tax**	**Revaluation account**
Opening Balance			
Day 2 Adjustment			
Closing Balance	$152,500	$152,500	$0

(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:

	Stock 1	**Stock 2**	**Stock 3**	**Stock 4**
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	
Day 3 Adjustment	$3,000	(3,000)	(2,000)	(1,000)
Total	$105,000	$102,000	$96,000	$151,500

X and Y

	Book	**Tax**	**Revaluation account**
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$150,000	$1,500
Gain from Stock 2	0	$1,000	(1,000)
Loss from Stock 3	0	($1,000)	1,000
Closing Balance	$151,500	$150,000	$1,500

Z

	Book	**Tax**	**Revaluation account**
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Gain from Stock 2	0	0	0
Loss from Stock 3	0	(2,000)	2,000
Closing Balance	$151,500	$150,500	$1,000

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 parntership'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 accoradnce 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:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	
Day 3 Adjustment	3,000	(3,000)	(2,000)	($1,000)
Total	$105,000	$102,000	$96,000	$151,500

X and Y

	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	$2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	(1,000)
Total	$151,500	$150,000	$1,500
Net Tax Loss-Stocks 2 & 3	0	(333)	333
Closing Balance	$151,500	$149,667	$1,833

Z

	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Net Tax Loss-Stocks 2 & 3	0	(1,333)	1,333
Closing Balance	$151,500	$151,167	$333

(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) *Applicability dates.* With the exception of paragraphs (a)(1), (a)(8)(ii) and (iii), (a)(10) and (11), and (e)(3)(vi)(C) of this section, and of the last sentence of paragraph (d)(2) of this section, this section applies to properties contributed to a partnership and to revaluations pursuant to § 1.704-1(b)(2)(iv)(*f*) or (*s*) 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 June 24, 2003. See § 1.752-7(k). Paragraphs (a)(1) and (a)(10) of this section are applicable for taxable years beginning after June 9, 2010. The last sentence of paragraph (d)(2) of this section applies to property contributed to a partnership on or after September 24, 2019. However, a taxpayer may choose to apply the last sentence in paragraph (d)(2) of this section for property contributed to a partnership on or after September 28, 2017. A taxpayer may rely on the last sentence in paragraph (d)(2) of this section in regulation project REG-104397-18 (2018-41 I.R.B. 558) (see § 601.601(d)(2)(ii)(b) of this chapter) for property contributed to a partnership on or after September 28, 2017, and ending before September 24, 2019. Paragraph (e)(3)(vi)(C) of this section applies to taxable years beginning on or after January 19, 2021.

(g) *Applicability dates for rules for section 721(c) partnerships* -

(1) *In general.* Notwithstanding paragraph (f) of this section, except as provided in paragraph (g)(2) of this section, paragraphs (a)(13) and (d)(5)(iii) of this section apply with respect to contributions occurring on or after January 18, 2017, and with respect to contributions that occurred before January 18, 2017 resulting from an entity classification election made under § 301.7701-3 of this chapter that was effective on or before January 18, 2017 but was filed on or after January 18, 2017.

(2) *Election to apply the provisions described in paragraph (g)(1) of this section retroactively.* Paragraphs (a)(13) and (d)(5)(iii) of this section may, by election, be applied with respect to a contribution that occurred on or after August 6, 2015 but before January 18, 2017, and with respect to a contribution that occurred before August 6, 2015 resulting from an entity classification election made under § 301.7701-3 of this chapter that was effective on or before August 6, 2015 but was filed on or after August 6, 2015. The election must have been made by applying paragraph (a)(13) or (d)(5)(iii) of this section, as applicable, on a timely filed original return (including extensions) or an amended return filed no later than July 18, 2017.

[T.D. 8500, 58 FR 67679, Dec. 22, 1993]

§ 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 § 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.

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock or any position in stock to which section 1032 applies of a corporation that holds a direct or indirect interest in the partnership, see § 1.705-2.

(8) For basis adjustments necessary to coordinate sections 705 and 358(h), see § 1.358-7(b). For certain basis adjustments with respect to a § 1.752-7 liability assumed by a partnership from a partner, see § 1.752-7.

(9) For basis adjustments necessary to coordinate sections 705 and 362(e)(2), see § 1.362-4(e)(1).

§ 1.706-1 Taxable years of partner and partnership.

(b) *Taxable year* -

(1) *Partnership treated as a taxpayer.* The taxable year of a partnership must be determined as though the partnership were a taxpayer.

(2) *Partnership's taxable year* -

(i) *Required taxable year.* Except as provided in paragraph (b)(2)(ii) of this section, the taxable year of a partnership must be -

(A) The majority interest taxable year, as defined in section 706(b)(4);

(B) If there is no majority interest taxable year, the taxable year of all of the principal partners of the partnership, as defined in 706(b)(3) (the principal partners' taxable year); or

(C) If there is no majority interest taxable year or principal partners' taxable year, the taxable year that produces the least aggregate deferral of income as determined under paragraph (b)(3) of this section.

(ii) *Exceptions.* A partnership may have a taxable year other than its required taxable year if it makes an election under section 444, elects to use a 52-53-week taxable year that ends with reference to its required taxable year or a taxable year elected under section 444, or establishes a business purpose for such taxable year and obtains approval of the Commissioner under section 442.

(3) *Least aggregate deferral* -

(i) *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 generally must be made as of the beginning of the partnership's current taxable year. The 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.

(ii) *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 (b)(3)(i) of this section, the taxable year of a partner or partnership that uses a 52-53-week taxable year must 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.

(iii) *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 will be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year.

(iv) *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:

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest × deferral
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31	Year end	Interest in partnership profits	Months of deferral for 7/31 year end	Interest × deferral
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

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:

Test 12/31	Year end	Interest in partnership profits	Months of deferral for 12/31 year end	Interest × deferral
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30	Year end	Interest in partnership profits	Months of deferral for 11/30 year end	Interest × deferral
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

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. The determination is made as follows:

Test 12/31	Year end	Interest in partnership profits	Months of deferral for 12/31 year end	Interest × deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest × deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

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:

Test 7/31	Year end	Interest in partnership profits	Months of deferral for 7/31 year end	Interest × deferral
Partner A	6/30	.06	11	.66
Partner B	7/31	.5	0	0
Partner C	6/30	.04	11	.44
Partner D	4/30	.4	9	3.60
Aggregate deferral				4.70

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest × deferral
Partner A	6/30	.06	0	0
Partner B	7/31	.5	1	.5
Partner C	6/30	.04	0	0
Partner D	4/30	.4	10	4.0
Aggregate deferral				4.5

Test 4/30	Year end	Interest in partnership profits	Months of deferral for 4/30 year end	Interest × deferral
Partner A	6/30	.06	2	.12
Partner B	7/31	.5	3	1.50
Partner C	6/30	.04	2	.08
Partner D	4/30	.4	0	0
Aggregate deferral				1.70

Test 4/30	Year end	Interest in partnership profits	Months of deferral for 4/30 year end	Interest × deferral

§ 1.706-1(b)(3) Test	
Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example 6.

(i) 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 paragraph (b)(3) of this section to be the fiscal year ending March 31 as follows:

Test 3/31	Year end	Interest in partnership profits	Deferral for 3/31 year end	Interest × deferral
Partner A	3/31	.5	0	0
Partner B	7/31	.5	4	2
Aggregate deferral				2

Test 7/31	Year end	Interest in partnership profits	Deferral for 7/31 year end	Interest × deferral
Partner A	3/31	.5	8	4
Partner B	7/31	.5	0	0
Aggregate deferral				4

(ii) 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 (b)(3)(iii) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year end	Interest in partnership profits	Deferral for 3/31 year end	Interest × deferral
Partner A	3/31	.05	0	0
Partner B	7/31	.5	4	2.0
Partner C	4/30	.45	1	.45
Aggregate deferral				2.45

Test 7/31	Year end	Interest in partnership profits	Deferral for 7/31 year end	Interest × deferral
Partner A	3/31	.05	8	.40
Partner B	7/31	.5	0	0
Partner C	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30	Year end	Interest in partnership profits	Deferral for 4/30 year end	Interest × deferral
Partner A	3/31	.05	11	.55
Partner B	7/31	.5	3	1.50
Partner C	4/30	.45	0	0
Aggregate deferral				2.05
§ 1.706-1(b)(3) 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)				.40

(4) *Measurement of partner's profits and capital interest* -

(i) *In general.* The rules of this paragraph (b)(4) apply in determining the majority interest taxable year, the principal partners' taxable year, and the least aggregate deferral taxable year.

(ii) *Profits interest* -

(A) *In general.* For purposes of section 706(b), a partner's interest in partnership profits is generally the partner's percentage share of partnership profits for the current partnership taxable year. If the partnership does not expect to have net income for the current partnership taxable year, then a partner's interest in partnership profits instead must be the partner's percentage share of partnership net income for the first taxable year in which the partnership expects to have net income.

(B) *Percentage share of partnership net income.* The partner's percentage share of partnership net income for a partnership taxable year is the ratio of: the partner's distributive share of partnership net income for the taxable year, to the partnership's net income for the year. If a partner's percentage share of partnership net income for the taxable year depends on the amount or nature of partnership income for that year (due to, for example, preferred returns or special allocations of specific partnership items), then the partnership must make a reasonable estimate of the amount and nature of its income for the taxable year. This estimate must be based on all facts and circumstances known to the partnership as of the first day of the current partnership taxable year. The partnership must then use this estimate in determining the partners' interests in partnership profits for the taxable year.

(C) *Distributive share.* For purposes of this paragraph (b)(4)(ii), a partner's distributive share of partnership net income is determined by taking into account all rules and regulations affecting that determination, including, without limitation, sections 704(b), (c), and (e), 736, and 743.

(iii) *Capital interest.* Generally, a partner's interest in partnership capital is determined by reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon liquidation of the partnership. If the partnership maintains capital accounts in accordance with § 1.704-1(b)(2)(iv), then for purposes of section 706(b), the partnership may assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts as of the first day of the partnership taxable year.

(5) *Taxable year of a partnership with tax-exempt partners* -

(i) *Certain tax-exempt partners disregarded.* 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 Internal Revenue 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 Internal Revenue Code, on any income attributable to such partner's investment in the partnership during the current year.

(ii) *Example.* The provisions of paragraph (b)(5)(i) of this section may be illustrated by the following example:

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, 2003. Under these facts and but for the special rule in paragraph (b)(5)(i) 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, 2003. However, under the special rule provided in paragraph (b)(5)(i) of this section 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.

(iii) *Effective date.* The provisions of this paragraph (b)(5) are applicable for taxable years beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see § 1.706-3T as contained in 26 CFR part 1 revised April 1, 2002.

(6) *Certain foreign partners disregarded* -

(i) *Interests of disregarded foreign partners not taken into account.* In determining the taxable year (the current taxable year) of a partnership under section 706(b) and the regulations thereunder, any interest held by a disregarded foreign partner is not taken into account. A foreign partner is a disregarded foreign partner unless such partner is allocated any gross income of the partnership that was effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States during the partnership's taxable year immediately preceding the current taxable year (or, if such partner was not a partner during the partnership's immediately preceding taxable year, the partnership reasonably believes that the partner will be allocated any such income during the current taxable year) and taxation of that income is not otherwise precluded under any U.S. income tax treaty.

(ii) *Definition of foreign partner.* For purposes of this paragraph (b)(6), a foreign partner is any partner that is not a United States person (as defined in section 7701(a)(30)), except that a partner that is a controlled foreign corporation (within the meaning of section 957(a)) in which a United States shareholder (as defined in section 951(b)) owns (within the meaning of section 958(a)) stock is not treated as a foreign partner.

(iii) *Minority interest rule.* If each partner that is not a disregarded foreign partner under paragraph (b)(6)(i) of this section (regarded partner) holds less than a 10-percent interest, and the regarded partners, in the aggregate, hold less than a 20-percent interest in the capital and profits of the partnership, then paragraph (b)(6)(i) of this section does not apply. In determining ownership in a partnership for purposes of this paragraph (b)(6)(iii), each regarded partner is treated as owning any interest in the partnership owned by a related partner. For this purpose, partners are treated as related if they are related within the meaning of sections 267(b) or 707(b) (using the language “10 percent” instead of “50 percent” each place it appears). However, for purposes of determining if partners hold less than a 20-percent interest in the aggregate, the same interests will not be considered as being owned by more than one regarded partner.

(iv) *Example.* The provisions of paragraph (b)(6) of this section may be illustrated by the following example:

Example.

Partnership B is owned by two partners, F, a foreign corporation that owns a 95-percent interest in the capital and profits of partnership B, and D, a domestic corporation that owns the remaining 5-percent interest in the capital and profits of partnership B. Partnership B is not engaged in the conduct of a trade or business within the United States, and, accordingly, partnership B does not earn any income that is effectively connected with a U.S. trade or business. F uses a March 31 fiscal year, and causes partnership B to maintain its books and records on a March 31 fiscal year as well. D is a calendar year taxpayer. Under paragraph (b)(6)(i) of this section, F would be disregarded and partnership B's taxable year would be determined by reference to D. However, because D owns less than a 10-percent interest in the capital and profits of partnership B, the minority interest rule of paragraph (b)(6)(iii) of this section applies, and partnership B must adopt the March 31 fiscal year for Federal tax purposes.

(v) *Applicability dates* -

(A) *Generally.* The provisions of this paragraph (b)(6) (other than paragraph (b)(6)(iii) of this section and paragraph (b)(6)(ii) of this section to the extent described in the next sentence) apply to partnership taxable years, other than those of an existing partnership, that begin on or after July 23, 2002. The provisions in paragraph (b)(6)(ii) of this section relating to controlled foreign corporations apply to taxable years of foreign corporations ending on or after October 1, 2019, and taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. For taxable years of foreign corporations ending before October 1, 2019, and taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, a taxpayer may apply such provisions to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent taxable year of the foreign corporation, and to taxable years of United States shareholders in which or with which such taxable years of the foreign corporation end, provided that the taxpayer and United States persons that are related (within the meaning of section 267 or 707) to the taxpayer consistently apply such provisions with respect to all foreign corporations. For taxable years of foreign corporations ending before October 1, 2019, and taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, where the taxpayer does not apply the provisions of paragraph (b)(6)(ii) of this section relating to controlled foreign corporations, see paragraph (b)(6)(ii) of this section as in effect and contained in 26 CFR part 1, as revised April 1, 2020. The provisions of paragraph (b)(6)(iii) of this section apply to partnership taxable years, other than those of an existing partnership or an interim period partnership, that begin on or after August 3, 2015. For partnership taxable years beginning on or after July 23, 2002, and before August 3, 2015, see the provisions of § 1.706-1(b)(6)(iii) as contained in the 26 CFR part 1 on July 31, 2015. For purposes of paragraph (b)(6) of this section, an existing partnership is a partnership that was formed prior to September 23, 2002, and an interim period partnership is a partnership that was formed on or after September 23, 2002, and prior to August 3, 2015.

(B) *Voluntary change in taxable year.* An existing partnership may change its taxable year to a year determined in accordance with this section. An existing partnership that makes such a change prior to August 3, 2015 will generally cease to be exempted from the requirements of this paragraph (b)(6) of this section, and thus will be subject to the requirements of paragraph (b)(6) of this section, except for paragraph (b)(6)(iii) of this section - instead, such partnership will be subject to the provisions of § 1.706-1(b)(6)(iii) as contained in the 26 CFR part 1 on July 31, 2015. An existing partnership that makes such a change on or after August 3, 2015 will cease to be exempted from the requirements of this paragraph (b)(6). An interim period partnership may change its taxable year to a year determined in accordance with paragraph (b)(6)(iii) of this section. An interim period partnership that makes such a change will cease to be exempted from the requirements of paragraph (b)(6)(iii) of this section.

(C) *Subsequent sale or exchange of interests.* If an existing partnership or an interim period partnership terminates under section 708(b)(1)(B), the resulting partnership is not an existing partnership or an interim period partnership for purposes of paragraph (b)(6)(v) of this section.

(D) *Transition rule.* If, in the first taxable year beginning on or after July 23, 2002, an existing partnership voluntarily changes its taxable year to a year determined in accordance with this paragraph (b)(6), then the partners of that partnership may apply the provisions of § 1.702-3T to take into account all items of income, gain, loss, deduction, and credit attributable to the partnership year of change ratably over a four-year period. If, in a partnership taxable year beginning on or after August 3, 2015, an interim period partnership voluntarily changes its taxable year to a year determined in accordance with paragraph (b)(6)(iii) of this section, then the partners of that partnership may apply the provisions of § 1.702-3T to take into account all items of income, gain, loss, deduction, and credit attributable to the partnership year of change ratably over a four-year period.

(7) *Adoption of taxable year.* A newly-formed partnership may adopt, in accordance with § 1.441-1(c), its required taxable year, a taxable year elected under section 444, or a 52-53-week taxable year ending with reference to its required taxable year or a taxable year elected under section 444 without securing the approval of the Commissioner. If a newly-formed partnership wants to adopt any other taxable year, it must establish a business purpose and secure the approval of the Commissioner under section 442.

(8) *Change in taxable year* -

(i) *Partnerships* -

(A) *Approval required.* An existing partnership may change its taxable year only by securing the approval of the Commissioner under section 442 or making an election under section 444. However, a partnership may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(B) *Short period tax return.* A partnership that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the partnership taxable income.

(C) *Change in required taxable year.* If a partnership is required to change to its majority interest taxable year, then no further change in the partnership's required taxable year is required for either of the two years following the year of the change. This limitation against a second change within a three-year period applies only if the first change was to the majority interest taxable year and does not apply following a change in the partnership's taxable year to the principal partners' taxable year or the least aggregate deferral taxable year.

(ii) *Partners.* Except as otherwise provided in the Internal Revenue Code or the regulations thereunder (e.g., section 859 regarding real estate investment trusts or § 1.442-2(c) regarding a subsidiary changing to its consolidated parent's taxable year), a partner may not change its taxable year without securing the approval of the Commissioner under section 442. However, certain partners may be eligible to obtain automatic approval to change their taxable years pursuant to the regulations or administrative procedures published by the Commissioner. A partner that changes its taxable year must make its return for a short period in accordance with section 443.

(9) *Retention of taxable year.* In certain cases, a partnership will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership, unless the partnership previously obtained approval for its current taxable year or, if appropriate, makes an election under section 444.

(10) *Procedures for obtaining approval or making a section 444 election.* See § 1.442-1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444-1T and 1.444-2T for qualifications, and § 1.444-3T for procedures, for making an election under section 444.

(11) *Effect of partner elections under section 444* -

(i) Election taken into account. 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 § 1.7519-1T(d), *Example (4).*

(ii) *Effective date.* The provisions of this paragraph (b)(11) are applicable for taxable years beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see § 1.706-3T as contained in 26 CFR part 1 revised April 1, 2002.

(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 § 1.708-1.

(2) *Disposition of entire interest* -

(i) *In general.* A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in the partnership, with respect to a partner whose entire interest in the partnership is liquidated, and with respect to a partner who dies. In the case of a death, liquidation, or sale or exchange of a partner's entire interest in the partnership, the partner shall include in his taxable income for his taxable year within or with which the partner's interest in the partnership ends the partner's distributive share of items described in section 702(a) and any guaranteed payments under section 707(c) for the partnership taxable year ending with the date of such termination. 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 the completion of the liquidation. 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.

(ii) *Example.* H is a partner 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, 2016. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 2016. Such distribution by the estate is not a sale or exchange of H's partnership interest. The taxable year of the partnership will close with respect to H on March 31, 2016, and H will include in his final return for his final taxable year (January 1, 2016, through March 31, 2016) his distributive share of partnership items for that period under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4. W will include in her return for the taxable year ending December 31, 2016, her distributive share of partnership items for the period of April 1, 2016, through December 31, 2016, under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4.

(iii) *Deemed dispositions.* A deemed disposition of the partner's interest pursuant to § 1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §§ 1.1502-1(h)), 1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or 1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner), shall be treated as a disposition of the partner's entire interest in the partnership solely for purposes of section 706.

(3) *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.

(4) *Determination of distributive shares.* See section 706(d)(2), 706(d)(3), and § 1.706-4 for rules regarding the methods to be used in determining the distributive shares of items described in section 702(a) for partners whose interests in the partnership vary during the partnership's taxable year as a result of a disposition of a partner's entire interest in a partnership as described in paragraph (c)(2) of this section or as a result of a disposition of less than a partner's entire interest as described in paragraph (c)(3) of this section.

(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).

(6) *Foreign taxes.* For rules relating to the treatment of foreign taxes paid or accrued by a partnership, see § 1.901-2(f)(4)(i) and (f)(4)(ii).

§ 1.706-4 Determination of distributive share when a partner's interest varies.

(a) *General rule* -

(1) *Variations subject to this section.* Except as provided in paragraph (a)(2) of this section, this section provides rules for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership as described in § 1.706-1(c)(2) and (3), or with respect to a partner whose interest in a partnership is reduced as described in § 1.706-1(c)(3), including by the entry of a new partner (collectively, a “variation”).

(2) Coordination with sections 706(d)(2) and 706(d)(3) and other Code sections. Items subject to allocation under other rules, including sections 108(e)(8) and 108(i) (which provide special allocation rules for certain items from the discharge or retirement of indebtedness section), section 704(c) (relating to allocations with respect to certain contributed property), § 1.704-3(a)(6) (relating to allocations with respect to revalued property), section 706(d)(2) (relating to the determination of partners' distributive shares of allocable cash basis items), and section 706(d)(3) (relating the determination of partners' distributive share of any item of an upper tier partnership attributable to a lower tier partnership), are not subject to the rules of this section. In addition, the rules of this section do not apply in making allocation of book items pursuant to § 1.704-1(b)(2)(iv)(*e*), (*f*), or (*s*). In all cases, all partnership items for each taxable year must be allocated among the partners, and no partnership items may be duplicated, regardless of the particular provision of section 706 (or other Code section) which applies, and regardless of the method or convention adopted by the partnership.

(3) *Allocation of items subject to this section.* In determining the distributive share under section 702(a) of partnership items subject to this section, the partnership shall follow the steps described in this paragraph (a)(3)(i) through (x).

(i) First, determine whether either of the exceptions in paragraph (b) of this section (regarding certain changes among contemporaneous partners and partnerships for which capital is not a material income-producing factor) applies.

(ii) Second, determine which of its items are subject to allocation under the special rules for extraordinary items in paragraph (e) of this section, and allocate those items accordingly.

(iii) Third, determine with respect to each variation whether it will apply the interim closing method or the proration method. Absent an agreement of the partners (within the meaning of paragraph (f) of this section) to use the proration method, the partnership shall use the interim closing method. The partnership may use different methods (interim closing or proration) for different variations within each partnership taxable year; however, the Commissioner may place restrictions on the ability of partnerships to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.

(iv) Fourth, determine when each variation is deemed to have occurred under the partnership's selected convention (as described in paragraph (c) of this section).

(v) Fifth, determine whether there is an agreement of the partners (within the meaning of paragraph (f) of this section) to perform regular monthly or semi-monthly interim closings (as described in paragraph (d) of this section). If so, then the partnership will perform an interim closing of its books at the end of each month (in the case of an agreement to perform monthly closings) or at the end and middle of each month (in the case of an agreement to perform semi-monthly closings), regardless of whether any variation occurs. Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's taxable year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method.

(vi) Sixth, determine the partnership's segments, which are specific periods of the partnership's taxable year created by interim closings of the partnership's books. The first segment shall commence with the beginning of the taxable year of the partnership and shall end at the time of the first interim closing. Any additional segment shall commence immediately after the closing of the prior segment and shall end at the time of the next interim closing. However, the last segment of the partnership's taxable year shall end no later than the close of the last day of the partnership's taxable year. If there are no interim closings, the partnership has one segment, which corresponds to its entire taxable year.

(vii) Seventh, apportion the partnership's items for the year among its segments. The partnership shall determine the items of income, gain, loss, deduction, and credit of the partnership for each segment. In general, a partnership shall treat each segment as though the segment were a separate distributive share period. For example, a partnership may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. For purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will be applied based upon the partnership's satisfaction of the limitation or requirement as of the end of the partnership's taxable year. For example, the expenses related to the election to expense a section 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method.

(viii) Eighth, determine the partnership's proration periods, which are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method. The first proration period in each segment begins at the beginning of the segment, and ends at the first time of the first variation within the segment for which the partnership selects the proration method. The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnership selects the proration method. However, each proration period shall end no later than the close of the segment.

(ix) Ninth, prorate the items of income, gain, loss, deduction, and credit in each segment among the proration periods within the segment.

(x) Tenth, determine the partners' distributive shares of partnership items under section 702(a) by taking into account the partners' interests in such items during each segment and proration period.

(4) *Example.*

At the beginning of 2017, PRS, a calendar year partnership, has three equal partners, A, B, and C. On April 16, 2017, A sells 50% of its interest in PRS to new partner D. On August 6, 2017, B sells 50% of its interest in PRS to new partner E. During 2015, PRS earned $75,000 of ordinary income, incurred $33,000 of ordinary deductions, earned $12,000 of capital gain in the ordinary course of its business, and sustained $9,000 of capital loss in the ordinary course of its business. Within that year, PRS earned $60,000 of ordinary income, incurred $24,000 of ordinary deductions, earned $12,000 of capital gain, and sustained $6,000 of capital loss between January 1, 2017, and July 31, 2017, and PRS earned $15,000 of gross ordinary income, incurred $9,000 of gross ordinary deductions, and sustained $3,000 of capital loss between August 1, 2017, and December 31, 2017. None of PRS's items are extraordinary items within the meaning of paragraph (e)(2) of this section. Capital is a material income-producing factor for PRS. For 2017, PRS determines the distributive shares of A, B, C, D, and E as follows:

(i) First, PRS determines that none of the exceptions in paragraph (b) of this section apply because capital is a material-income producing factor and no variation is the result of a change in allocations among contemporaneous partners.

(ii) Second, PRS determines that none of its items are extraordinary items subject to allocation under paragraph (e) of this section.

(iii) Third, the partners of PRS agree (within the meaning of paragraph (f) of this section) to apply the proration method to the April 16, 2017, variation, and PRS accepts the default application of the interim closing method to the August 6, 2017, variation.

(iv) Fourth, PRS determines the deemed date of the variations for purposes of this section based upon PRS's selected convention. Because PRS applied the proration method to the April 16, 2017, variation, PRS must use the calendar day convention with respect to the April 16, 2017, variation pursuant to paragraph (c) of this section. Therefore, the variation that resulted from A's sale to D on April 16, 2017, is deemed to occur for purposes of this section at the end of the day on April 16, 2017. Further, the partners of PRS agree (within the meaning of paragraph (f) of this section) to apply the semi-monthly convention to the August 6, 2017, variation. Therefore, the August 6, 2017, variation is deemed to occur at the end of the day on July 31, 2017.

(v) Fifth, the partners of PRS do not agree to perform regular semi-monthly or monthly closings as described in paragraph (d) of this section. Therefore, PRS will have only one interim closing for 2017, occurring at the end of the day on July 31.

(vi) Sixth, PRS determines that it has two segments for 2017. The first segment commences January 1, 2017, and ends at the close of the day on July 31, 2017. The second segment commences at the beginning of the day on August 1, 2017, and ends at the close of the day on December 31, 2017.

(vii) Seventh, PRS determines that during the first segment of its taxable year (beginning January 1, 2017, and ending July 31, 2017), it had $60,000 of ordinary income, $24,000 of ordinary deductions, $12,000 of capital gain, and $6,000 of capital loss. PRS determines that during the second segment of its taxable year (beginning August 1, 2017, and ending December 31, 2017), it had $15,000 of gross ordinary income, $9,000 of gross ordinary deductions, and $3,000 of capital loss.

(viii) Eighth, PRS determines that it has two proration periods. The first proration period begins January 1, 2017, and ends at the close of the day on April 16, 2017; the second proration period begins April 17, 2017, and ends at the close of the day on July 31, 2017.

(ix) Ninth, PRS prorates its income from the first segment of its taxable year among the two proration periods. Because each proration period has 106 days, PRS allocates 50% of its items from the first segment to each proration period. Thus, each proration period contains $30,000 gross ordinary income, $12,000 gross ordinary deductions, $6,000 capital gain, and $3,000 capital loss.

(x) Tenth, PRS calculates each partner's distributive share. Because A, B, and C were equal partners during the first proration period, each is allocated one-third of the partnership's items attributable to that proration period. Thus, A, B, and C are each allocated $10,000 gross ordinary income, $4,000 gross ordinary deductions, $2,000 capital gain, and $1,000 capital loss for the first proration period. For the second proration period, A and D each had a one-sixth interest in PRS and B and C each had a one-third interest in PRS. Thus, A and D are each allocated $5,000 gross ordinary income, $2,000 gross ordinary deductions, $1,000 capital gain, and $500 capital loss, and B and C are each allocated $10,000 gross ordinary income, $4,000 gross ordinary deductions, $2,000 capital gain, and $1,000 capital loss for the second proration period. For the second segment of PRS's taxable year, A, B, D, and E each had a one-sixth interest in PRS and C had a one-third interest in PRS. Thus, A, B, D, and E are each allocated $2,500 gross ordinary income, $1,500 gross ordinary deductions, and $500 capital loss, and C is allocated $5,000 gross ordinary income, $3,000 gross ordinary deductions, and $1,000 capital loss for the second segment.

(b) *Exceptions* -

(1) *Permissible changes among contemporaneous partners.* The general rule of paragraph (a)(3) of this section, with respect to the varying interests of a partner described in § 1.706-1(c)(3), will not preclude changes in the allocations of the distributive share of items described in section 702(a) among contemporaneous partners for the entire partnership taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment), provided that -

(i) Any variation in a partner's interest is not attributable to a contribution of money or property by a partner to the partnership or a distribution of money or property by the partnership to a partner; and

(ii) The allocations resulting from the modification satisfy the provisions of section 704(b) and the regulations promulgated thereunder.

(2) *Safe harbor for partnerships for which capital is not a material income-producing factor.* Notwithstanding paragraph (a)(3) of this section, with respect to any taxable year in which there is a change in any partner's interest in a partnership for which capital is not a material income-producing factor, the partnership and such partner may choose to determine the partner's distributive share of partnership income, gain, loss, deduction, and credit using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year provided that the allocations satisfy the provisions of section 704(b).

(c) *Conventions* -

(1) *In general.* Conventions are rules of administrative convenience that determine when each variation is deemed to occur for purposes of this section. Because the timing of each variation is necessary to determine the partnership's segments and proration periods, which are used to determine the partners' distributive shares, the convention used by the partnership with respect to a variation will generally affect the allocation of partnership items. However, see paragraph (e) of this section for special rules regarding extraordinary items, which generally must be allocated without regard to the partnership's convention. Subject to the limitations set forth in paragraphs (c)(2) and (3) of this section, partnerships may generally choose from the following three conventions:

(i) *Calendar day convention.* Under the calendar day convention, each variation is deemed to occur for purposes of this section at the end of the day on which the variation occurs.

(ii) *Semi-monthly convention.* Under the semi-monthly convention, each variation is deemed to occur for purposes of this section either:

(A) In the case of a variation occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the immediately preceding calendar month; or

(B) In the case of a variation occurring on the 16th through the last day of a calendar month, at the end of the 15th calendar day of that month.

(iii) *Monthly convention.* Under the monthly convention, each variation is deemed to occur for purposes of this section either:

(A) In the case of a variation occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the immediately preceding calendar month; or

(B) In the case of a variation occurring on the 16th through the last day of a calendar month, at the end of the last day of that calendar month.

(2) *Exceptions.*

(i) Notwithstanding paragraph (c)(1) of this section, all variations within a taxable year shall be deemed to occur no earlier than the first day of the partnership's taxable year, and no later than the close of the final day of the partnership's taxable year. Thus, in the case of a calendar year partnership applying either the semi-monthly or monthly convention to a variation occurring on January 1st through January 15th, the variation will be deemed to occur for purposes of this section at the beginning of the day on January 1st.

(ii) In the case of a partner who becomes a partner during the partnership's taxable year as a result of a variation, and ceases to be a partner as a result of another variation, if both such variations would be deemed to occur at the same time under the rules of paragraph (c)(1) of this section, then the variations with respect to that partner's interest will instead be treated as occurring on the dates each variation actually occurred. Thus, the partnership must treat such a partner as a partner for the entire portion of its taxable year during which the partner actually owned an interest. See *Example 2* of paragraph (c)(4) of this section. However, this paragraph (c)(2)(ii) does not apply to publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships with respect to holders of publicly traded units (as described in § 1.7704-1(b) or 1.7704-1(c)(1)).

(iii) Notwithstanding paragraph (c)(1)(iii) of this section, a publicly traded partnership (as defined in section 7704(b)) that is treated as a partnership may consistently treat all variations occurring during each month as occurring at the end of the last day of that calendar month if the publicly traded partnership uses the monthly convention for those variations.

(3) *Permissible conventions for each variation* -

(i) *Rules applicable to all partnerships.* A partnership generally shall use the calendar day convention for each variation; however, for all variations during a taxable year for which the partnership uses the interim closing method, the partnership may instead use the semi-monthly or monthly convention by agreement of the partners (within the meaning of paragraph (f) of this section). The partnership must use the same convention for all variations for which the partnership uses the interim closing method.

(ii) *Publicly traded partnerships.* A publicly traded partnership (as defined in section 7704(b)) that is treated as a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) use any of the calendar day, the semi-monthly, or the monthly conventions with respect to all variations during the taxable year relating to its publicly-traded units (as described in § 1.7704-1(b) or (c)(1)), regardless of whether the publicly traded partnership uses the proration method with respect to those variations. A publicly traded partnership must use the same convention for all variations during the taxable year relating to its publicly traded units. A publicly traded partnership must use the calendar day convention with respect to all variations relating to its non-publicly traded units for which the publicly traded partnership uses the proration method.

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

Example 1.

PRS is a calendar year partnership with four equal partners A, B, C, and D. PRS is not a publicly traded partnership. PRS has the following three variations that occur during its 2016 taxable year: on March 11, A sells its entire interest in PRS to new partner E; on June 12, PRS partially redeems B's interest in PRS with a distribution comprising a partial return of B's capital; on October 21, C sells part of C's interest in PRS to new partner E. These transfers do not result in a termination of PRS under section 708. Pursuant to paragraph (a)(3)(iii) of this section, the partners of PRS agree (within the meaning of paragraph (f) of this section) to use the interim closing method with respect to the variations occurring on March 11 and October 21 and agree to use the proration method with respect to the variation occurring on June 12. Pursuant to paragraph (c)(3) of this section, the partners of PRS may agree (within the meaning of paragraph (f) of this section) to use any of the calendar day, semi-monthly, or monthly conventions with respect to the March 11 and October 21 variations, but must use the same convention for both variations. If the partners of PRS agree to use the calendar day convention, the March 11 and October 21 variations will be deemed to occur for purposes of this section at the end of the day on March 11, 2016, and October 21, 2016, respectively. If the partners of PRS agree to use the semi-monthly convention, the March 11 and October 21 variations will be deemed to occur for purposes of this section at the end of the day on February 29, 2016, and October 15, 2016, respectively. If the partners of PRS agree to use the monthly convention, the March 11 and October 21 variations will be deemed to occur for purposes of this section at the end of the day on February 29, 2016, and October 31, 2016, respectively. Pursuant to paragraph (c)(3) of this section PRS must use the calendar day convention with respect to the June 12 variation; thus, the June 12 variation is deemed to occur for purposes of this section at the end of the day on June 12, 2016.

Example 2.

PRS is a calendar year partnership that uses the interim closing method and monthly convention to account for variations during its taxable year. PRS is not a publicly traded partnership. On January 20, 2016, new partner A purchases an interest in PRS from one of PRS's existing partners. On February 14, 2016, A sells its entire interest in PRS. These transfers do not result in a termination of PRS under section 708. Under the rules of paragraph (c)(1)(iii) of this section, the January 20, 2016, variation and the February 14, 2016, variation would both be deemed to occur at the same time: the end of the day on January 31, 2016. Therefore, under the exception in paragraph (c)(2)(ii) of this section, the rules of paragraph (c)(1) of this section do not apply, and instead the January 20, 2016, variation and the February 14 variation are considered to occur on January 20, 2016, and February 14, 2016, respectively. PRS must perform a closing of the books on both January 20, 2016, and February 14, 2016, and allocate A a share of PRS's items attributable to that segment.

(d)

(1) *Optional regular monthly or semi-monthly interim closings.* Under the rules of this section, a partnership is not required to perform an interim closing of its books except at the time of any variation for which the partnership uses the interim closing method (taking into account the applicable convention). However, a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) perform regular monthly or semi-monthly interim closings of its books,

regardless of whether any variation occurs. Regardless of whether the partners agree to perform these regular interim closings, the partnership must continue to apply the interim closing or proration method to its variations according to the rules of this section.

(2) *Example.* The following example illustrates the principles in this paragraph (d).

Example.

(i) PRS is a calendar year partnership with five equal partners A, B, C, D, and E. PRS has the following two variations that occur during its 2016 taxable year: on August 29, A sells its entire interest in PRS to new partner F; on December 27, PRS completely liquidates B's interest in PRS with a distribution. These variations do not result in a termination of PRS under section 708.

(ii) The partners of PRS agree (within the meaning of paragraph (f) of this section) to use the interim closing method and the semi-monthly convention with respect to the variation occurring on August 29. Thus, the August variation is deemed to occur for purposes of this section at the end of the day on August 15, 2016. The partners of PRS agree (within the meaning of paragraph (f) of this section) to use the proration method with respect to the December 27 variation. Therefore, PRS must use the calendar day convention with respect to the December variation pursuant to paragraph (c) of this section. Thus, the December variation is deemed to occur for purposes of this section at the end of the day on December 27, 2016.

(iii) Pursuant to paragraph (d)(1) of this section, the partners of PRS agree (within the meaning of paragraph (f) of this section) to perform regular monthly interim closings. Therefore, PRS will have twelve interim closings for its 2016 taxable year, one at the end of every month and one at the end of the day on August 15. Therefore, PRS will have thirteen segments for 2016, one corresponding to each month from January through July, one segment from August 1 through August 15, one segment from August 16 through August 31, and one corresponding to each month from September through December. PRS must apportion its items among these segments under the rules of paragraph (a)(3) of this section.

(iv) PRS will have two proration periods for 2016, one from December 1 through December 27, and one from December 28 through December 31. Pursuant to the rules of paragraph (a)(3) of this section, PRS will prorate the items in its December segment among these two proration periods. Therefore, PRS will apportion 27/31 of all items in its December segment to the proration period from December 1 through December 27, and 4/31 of all items in its December segment to the proration period from December 28 through December 31.

(v) Pursuant to the rules of paragraph (a)(3)(x) of this section, PRS determines the partners' distributive shares of partnership items under section 702(a) by taking into account the partners' interests in such items during each of the thirteen segments and two proration periods. Thus, A, B, C, D, and E will each be allocated one-fifth of all items in the following segments: January, February, March, April, May, June, July, and August 1 through August 15. B, C, D, E, and F will each be allocated one-fifth of all items in the following segments: August 16 through August 31, September, October, and November. B, C, D, E, and F will each be allocated one-fifth of all items in the proration period from December 1 through December 27. C, D, E, and F will each be allocated one-quarter of all items in the proration period from December 28 through December 31.

(e) *Extraordinary items* -

(1) *General principles.* Extraordinary items may not be prorated. The partnership must allocate extraordinary items among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred, regardless of the method (interim closing or proration method) and convention (daily, semi-monthly, or monthly) otherwise used by the partnership. These rules require the allocation of extraordinary items as an exception to the proration method, which would

otherwise ratably allocate the extraordinary items across the segment, and the conventions, which could otherwise inappropriately shift extraordinary items between a transferor and transferee. However, publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships may, but are not required to, apply their selected convention in determining who held publicly traded units (as described in § 1.7704-1(b) or (c)(1)) at the time of the occurrence of an extraordinary item. Extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

(2) *Definition.* Except as provided in paragraph (e)(3) of this section, an extraordinary item is:

(i) Any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset as defined in section 1221 (determined without the application of any other rules of law);

(ii) Any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement);

(iii) Any item from the disposition or abandonment of an asset described in section 1221(a)(1), (a)(3), (a)(4), or (a)(5) if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions);

(iv) Any item from assets disposed of in an applicable asset acquisition under section 1060(c);

(v) Any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs;

(vi) Any item from the discharge or retirement of indebtedness (except items subject to section 108(e)(8) or 108(i), which are subject to special allocation rules provided in section 108(e)(8) and 108(i));

(vii) Any item from the settlement of a tort or similar third-party liability or payment of a judgment;

(viii) Any credit, to the extent it arises from activities or items that are not ratably allocated (for example, the rehabilitation credit under section 47, which is based on placement in service);

(ix) For all partnerships, any additional item if, the partners agree (within the meaning of paragraph (f) of this section) to consistently treat such item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses);

(x) Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included;

(xi) Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.

(3) *Small item exception.* A partnership may treat an item described in paragraph (e)(2) of this section as other than an extraordinary item for purposes of this paragraph (e) if, for the partnership's taxable year the total of all items in the particular class of extraordinary items (as enumerated in paragraphs (e)(2)(i) through (xi) of this section, for example, all tort or similar liabilities, but in no event counting an extraordinary item more than once) is less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross

expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items; and the total amount of the extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

(4) *Examples.* The following examples illustrate the provisions of this paragraph (e).

Example 1.

PRS, a calendar year partnership, uses the proration method and calendar day convention to account for varying interests of the partners. At 3:15 p.m. on December 7, 2015, PRS recognizes an extraordinary item within the meaning of paragraph (e)(2) of this section. On December 12, 2016, A, a partner in PRS, disposes of its entire interest in PRS. PRS does not experience a termination under section 708 during 2016. PRS has no other extraordinary items for the taxable year, the small item exception of paragraph (e)(3) of this section does not apply, the exceptions in paragraph (b) of this section do not apply, and PRS is not a publicly traded partnership. Pursuant to paragraph (e)(1) of this section, the item of income, gain, loss, deduction, or credit attributable to the extraordinary item will be allocated in accordance with the partners' interests in the extraordinary item at 3:15 p.m. on December 7, 2016. The remaining partnership items of PRS that are subject to this section must be prorated across the partnership's taxable year in accordance with paragraph (a)(3) of this section.

Example 2.

Assume the same facts as in Example 1, except that PRS uses the interim closing method and monthly convention to account for varying interests of the partners. Pursuant to paragraph (c)(1)(iii) of this section, the December 12 variation is deemed to have occurred for purposes of this section at the end of the day on November 30, 2016. Thus, A will not generally be allocated any items of PRS attributable to the segment between December 1, 2016, and December 31, 2016; however, pursuant to paragraph (e)(1) of this section, PRS must allocate the item of income, gain, loss, deduction, or credit attributable to the extraordinary item in accordance with the partners' interests in the extraordinary item at the time of day on which the extraordinary item occurred, regardless of the convention used by PRS. Thus, because A was a partner in PRS at 3:15 p.m. on December 7, 2016 (ignoring application of PRS's convention), A must be allocated a share of the extraordinary item.

Example 3.

Assume the same facts as in *Example 2,* except that PRS is a publicly traded partnership (within the meaning of section 7704(b)) and A held a publicly traded unit (as described in § 1.7704-1(b) or 1.7704-1(c)(1)) in PRS. Under PRS's monthly convention, the December 12 variation is deemed to have occurred for purposes of this section at the end of the day on November 30, 2016. Pursuant to paragraph (e)(1) of this section, a publicly traded partnership (as defined in section 7704(b)) may choose to respect its conventions in determining who held its publicly traded units (as described in § 1.7704-1(b) or § 1.7704-1(c)(1)) at the time of the occurrence of an extraordinary item. Therefore, PRS may choose to treat A as not having been a partner in PRS for purposes of this paragraph (e) at the time the extraordinary item arose, and thus PRS may choose not to allocate A any share of the extraordinary item.

Example 4.

A and B each own a 15 percent interest in PRS, a partnership that is not a publicly traded partnership and for which capital is a material income-producing factor. At 9:00 a.m. on April 25, 2016, A sells its entire interest in PRS to new partner D. At 3:00 p.m. on April 25, 2016, PRS incurs an extraordinary item (within the meaning of paragraph (e)(2) of this section). At 5:00 p.m. on April 25, 2016, B sells its entire interest in PRS to new partner E. Under paragraph (e)(1) of this section, PRS must allocate the extraordinary item in accordance with the partners' interests at 3:00 p.m. on April 25, 2016. Accordingly, a portion of the extraordinary item will be allocated to each of B and D, but no portion will be allocated to A or E.

Example 5.

PRS, a calendar year partnership that is not a publicly traded partnership, has a variation in a partner's interest during 2016 and the exceptions in paragraph (b) of this section do not apply. During 2016 PRS has two extraordinary items: PRS recognizes $8 million of gross income on the sale outside the ordinary course of business of an asset described in paragraph (e)(2)(ii) of this section, and PRS also recognizes $12 million of gross income from a tort settlement as described in paragraph (e)(2)(vii) of this section. PRS's gross income (including the gross income from the extraordinary items) for the taxable year is $200 million. The gain from all items described in paragraph (e)(2)(ii) of this section is less than five percent of PRS's gross income ($8 million gross income from the asset sale divided by $200 million total gross income, or four percent) and all of the extraordinary items of PRS from classes that are less than five percent of PRS's gross income ($8 million), in the aggregate, do not exceed $10 million for the taxable year. Thus, the $8 million gain recognized on the asset sale is considered a small item under paragraph (e)(3) of this section and is therefore excepted from the rules of paragraph (e)(1) of this section. Because the gross income attributable to the tort settlement exceeds five percent of PRS's gross income (six percent), the tort settlement gross income is not considered a small item under paragraph (e)(3) of this section. Therefore, the $12 million gross income attributable to the tort settlement must be allocated according to the rules of paragraph (e)(1) of this section in accordance with PRS's partners' interests in the item at the time of the day that the tort settlement income arose.

Example 6.

Assume the same facts as Example 5, except that during the year, PRS also recognizes two additional extraordinary items: $2 million of gross income from the sale of a capital asset described in paragraph (e)(2)(i) of this section, and $1 million of gross income from discharge of indebtedness described in paragraph (e)(2)(vi) of this section. Although the gain from items described in each of paragraphs (e)(2)(i), (e)(2)(ii), and (e)(2)(vi) of this section is each less than five percent of PRS's gross income, the extraordinary items of PRS from classes that are less than five percent of PRS's gross income ($11 million), in the aggregate, exceeds $10 million for the taxable year. Thus, none of the items are considered small items under paragraph (e)(3) of this section. Therefore, the items attributable to the sale of the capital asset, the sale of the trade or business asset, the discharge of indebtedness income, and the tort settlement must each be allocated according to the rules of paragraph (e)(1) of this section in accordance with PRS's partners' interests in the items at the time of the day that the items arose.

(f) *Agreement of the partners.* For purposes of paragraphs (a)(3)(iii) (relating to selection of the proration method), (c)(3) (relating to selection of the semi-monthly or monthly convention), (d) (relating to performance of regular monthly or semi-monthly interim closings), and (e)(2)(ix) (relating to selection of additional extraordinary items) of this section, the term agreement of the partners means either an agreement of all the partners to select the method, convention, or extraordinary item in a dated, written statement maintained with the partnership's books and records, including, for example, a selection that is included in the partnership agreement, or a selection of the method, convention, or extraordinary item made by a person authorized to make that selection, including under a grant of general authority provided for by either state law or in the partnership agreement, if that person's selection is in a dated, written statement maintained with the partnership's books and records. In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.

(g) *Effective/applicability date.* Except with respect to paragraph (c)(3) of this section, this section applies for partnership taxable years that begin on or after August 3, 2015. The rules of paragraph (c)(3) of this section apply for taxable years of partnerships other than existing publicly traded partnerships that begin on or after August 3, 2015. For purposes of the immediately preceding sentence, an existing publicly traded partnership is a partnership described in section 7704(b) that was formed prior to April 14, 2009. For purposes of this effective date provision, the termination of a publicly traded partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether the publicly traded partnership is an existing publicly traded partnership.

[T.D. 9728, 80 FR 45878, Aug. 3, 2015; 80 FR 68243, 68244, Nov. 4, 2015]

§ 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 § 1.731-1.

(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 § 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:

§ 1.708-1 Continuation of partnership.

(b) *Termination* -

(1) *General rule.* 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. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(i) 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.

(ii) 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 § 1.736-1.

(2) 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), 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 § 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 50 percent or more of the total interest in partnership 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.

(3) 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 § 1.706-1. The date of termination is:

(i) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

(ii) 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.

(4) 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) of this section. This paragraph (b)(4) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(4) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(4) to the termination in a consistent manner. The provisions of this paragraph (b)(4) 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 § 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 § 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 § 1.704-3(a)(3)(i) (providing that property contributed to a new partnership under § 1.708-1(b)(4) 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).

(5) 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)(5) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(5) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(5) to the termination in a consistent manner.

(6) *Treatment of certain start-up or organizational expenses following a technical termination* -

(i) *In general.* If a partnership that has elected to amortize start-up expenditures under section 195(b) or organizational expenses under section 709(b)(1) terminates in a transaction (or a series of transactions) described in section 708(b)(1)(B) or paragraph (b)(2) of this section, the new partnership must continue to amortize those expenditures over the remaining portion of the amortization period adopted by the terminating partnership. See section 195 and § 1.195-1 for rules concerning the amortization of start-up expenditures and section 709 and § 1.709-1 for rules concerning the amortization of organizational expenses.

(ii) *Effective/applicability date.* This paragraph (b)(6) applies to a technical termination of a partnership under section 708(b)(1)(B) that occurs on or after December 9, 2013.

§ 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 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.

§ 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]

§ 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,

§ 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).

(c) *Allocation of basis among properties distributed to a partner* -

(1) *General rule* -

(i) *Unrealized receivables and inventory items.* Except as provided in paragraph (c)(1)(iii) of this section, 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 § 1.732-1(c)(2)(i). See § 1.460-4(k)(2)(iv)(D) for a rule determining the partnership's basis in long-term contract accounted for under a long-term contract method of accounting.

(ii) *Other distributed property.* Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section or to stock of persons that control the corporate partner or to the corporate partner's stock under paragraph (c)(1)(iii) 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 § 1.732-1(c)(2).

(iii) *Stock distributed to the corporate partner.* If a partnership makes a distribution described in § 1.337(d)-3(e)(1), then for purposes of this section, the basis to be allocated to properties distributed under section 732(a)(2) or (b) is allocated first to the Stock of the Corporate Partner, as defined in § 1.337(d)-3(c)(2), before the distribution of any other property (other than cash). The amount allocated to the Stock of the Corporate Partner is as provided in § 1.337(d)-3(e)(2).

(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 × $50), and $10 to Asset Y (100/500 × $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/applicability date* -

(i) *In general.* This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(ii) *Exception.* Notwithstanding paragraph (c)(5)(i) of this section, the first sentence of each of paragraphs (c)(1)(i) and (ii) of this section, and paragraph (c)(1)(iii) of this section in its entirety, apply to distributions of Stock of the Corporate Partner, as defined in § 1.337(d)-3(c)(2), that occur on or after June 12, 2015.

§ 1.732-2 Special partnership basis of distributed property.

(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 § 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:

§ 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 §§ 1.732-1 and 1.732-2.

§ 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.

See § 1.460-4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting. The provisions of this paragraph (b)(1) are 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:

Assets

	Adjusted basis	Value
Cash	$4,000	$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

Liabilities and Capital

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

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 § 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:		
J	11,000	10,000
K	11,000	10,000
L	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 § 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 § 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. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69908, Dec. 15, 1999; T.D. 9137, 69 FR 42559, July 16, 2004]

§ 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 § 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 § 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 § 1.771-1. However, see section 771(c).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

§ 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 § 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 §§ 1.752-1 and 1.1001-2.

(e) For rules relating to the capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or section 1250 property with section 1250 capital gain, see § 1.1(h)-1. This paragraph (e) applies to transfers of interests in partnerships that occur on or after September 21, 2000.

(f) For rules relating to dividing the holding period of an interest in a partnership, see § 1.1223-3. This paragraph (f) applies to transfers of partnership interests and distributions of property from a partnership that occur on or after September 21, 2000.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980; T.D. 8902, 65 FR 57099, Sept. 21, 2000]

§ 1.743-1 Optional adjustment to basis of partnership property.

(a) *Generally.* The basis of partnership property is adjusted as a result of the transfer of an interest in a partnership by sale or exchange or on the death of a partner only if the election provided by section 754 (relating to optional adjustments to the basis of partnership property) is in effect with respect to the partnership. Whether or not the election provided in section 754 is in effect, the basis of partnership property is not adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Determination of adjustment.* In the case of the transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership that has an election under section 754 in effect -

(1) Increases the adjusted basis of partnership property by the excess of the transferee's basis for the transferred partnership interest over the transferee's share of the adjusted basis to the partnership of the partnership's property; or

(2) Decreases the adjusted basis of partnership property by the excess of the transferee's share of the adjusted basis to the partnership of the partnership's property over the transferee's basis for the transferred partnership interest.

(c) *Determination of transferee's basis in the transferred partnership interest.* In the case of the transfer of a partnership interest by sale or exchange or as a result of the death of a partner, the transferee's basis in the transferred partnership interest is determined under section 742 and § 1.742-1. See also section 752 and §§ 1.752-1 through 1.752-5.

(d) *Determination of transferee's share of the adjusted basis to the partnership of the partnership's property* -

(1) *Generally.* A transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus

the transferee's share of partnership liabilities. Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to -

(i) The amount of cash that the transferee would receive on a liquidation of the partnership following the hypothetical transaction, as defined in paragraph (d)(2) of this section (to the extent attributable to the acquired partnership interest); increased by

(ii) The amount of tax loss (including any remedial allocations under § 1.704-3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

(iii) The amount of tax gain (including any remedial allocations under § 1.704-3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

(2) *Hypothetical transaction defined.* For purposes of paragraph (d)(1) of this section, the hypothetical transaction means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets. See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

(3) *Examples.* The provisions of this paragraph (d) are illustrated by the following examples:

Example 1.

(i) A is a member of partnership PRS in which the partners have equal interests in capital and profits. The partnership has made an election under section 754, relating to the optional adjustment to the basis of partnership property. A sells its interest to T for $22,000. The balance sheet of the partnership at the date of sale shows the following:

Assets

	Adjusted basis	**Fair market value**
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	55,000	76,000

Liabilities and Capital

	Adjusted per books	**Fair market value**
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of T's interest in the partnership and T's share of the adjusted basis to the partnership of the partnership's property. Under section 742, the basis of T's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, T's share of partnership liabilities). T's interest in the partnership's previously taxed capital is $15,000 ($22,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to T from the hypothetical transaction). T's share of the adjusted basis to the partnership of the partnership's property is $18,333 ($15,000 share of previously taxed capital, plus $3,333 share of the partnership's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $7,000, the difference between $25,333 and $18,333.

Example 2.

A, B, and C form partnership PRS, to which A contributes land (Asset 1) with a fair market value of $1,000 and an adjusted basis to A of $400, and B and C each contribute $1,000 cash. Each partner has $1,000 credited to it on the books of the partnership as its capital contribution. The partners share in profits equally. During the partnership's first taxable year, Asset 1 appreciates in value to $1,300. A sells its one-third interest in the partnership to T for $1,100, when an election under section 754 is in effect. The amount of tax gain that would be allocated to T from the hypothetical transaction is $700 ($600 section 704(c) built-in gain, plus one-third of the additional gain). Thus, T's interest in the partnership's previously taxed capital is $400 ($1,100, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $700, T's share of gain from the hypothetical transaction). The amount of T's basis adjustment under section 743(b) to partnership property is $700 (the excess of $1,100, T's cost basis for its interest, over $400, T's share of the adjusted basis to the partnership of partnership property).

(e) *Allocation of basis adjustment.* For the allocation of the basis adjustment under this section among the individual items of partnership property, see section 755 and the regulations thereunder.

(j) *Effect of basis adjustment* -

(1) *In general.* The basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee only. No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under section 743(b) and this section. The adjustment to the basis of partnership property under section 743(b) has no effect on the partnership's computation of any item under section 703.

(2) *Computation of 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 transferee, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the transferee's distributive share of the items of partnership income, deduction, gain, or loss, in accordance with paragraphs (j)(3) and (4) of this section, to reflect the effects of the transferee's basis adjustment under section 743(b). These adjustments to the transferee's distributive shares must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). These adjustments to the transferee's distributive shares do not affect the transferee's capital account. See § 1.460-4(k)(3)(v)(B) for rules relating to the effect of a basis adjustment under section 743(b) that is allocated to a contract accounted for under a long-term contract method of accounting in determining the transferee's distributive share of income or loss from the contract.

(3) *Effect of basis adjustment in determining items of income, gain, or loss* -

(i) *In general.* The amount of a transferee's income, gain, or loss from the sale or exchange of a partnership asset in which the transferee has a basis adjustment is equal to the transferee's share of the partnership's gain or loss from the sale of the asset (including any remedial allocations under § 1.704-3(d)), minus the amount of the transferee's positive basis adjustment for the partnership asset (determined by taking into account the recovery of the basis adjustment under paragraph (j)(4)(i)(B) of this section) or plus the amount of the transferee's negative basis adjustment for the partnership asset (determined by taking into the account the recovery of the basis adjustment under paragraph (j)(4)(ii)(B) of this section).

(ii) *Examples.* The following examples illustrate the principles of this paragraph (j)(3):

Example 1.

A and B form equal partnership PRS. A contributes nondepreciable property with a fair market value of $50 and an adjusted tax basis of $100. PRS will use the traditional allocation method under § 1.704-3(b). B contributes $50 cash. A sells its interest to T for $50. PRS has an election in effect to adjust the basis of partnership property under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS then sells the property for $60. PRS recognizes a book gain of $10 (allocated equally between T and B) and a tax loss of $40. T will receive an allocation of $40 of tax loss under the principles of section 704(c). However, because T has a negative $50 basis adjustment in the nondepreciable property, T recognizes a $10 gain from the partnership's sale of the property.

Example 2.

A and B form equal partnership PRS. A contributes nondepreciable property with a fair market value of $100 and an adjusted tax basis of $50. B contributes $100 cash. PRS will use the traditional allocation method under § 1.704-3(b). A sells its interest to T for $100. PRS has an election in effect to adjust the basis of partnership property under section 754. Therefore, T receives a $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS then sells the nondepreciable property for $90. PRS recognizes a book loss of $10 (allocated equally between T and B) and a tax gain of $40. T will receive an allocation of the entire $40 of tax gain under the principles of section 704(c). However, because T has a $50 basis adjustment in the property, T recognizes a $10 loss from the partnership's sale of the property.

Example 3.

A and B form equal partnership PRS. PRS will make allocations under section 704(c) using the remedial allocation method described in § 1.704-3(d). A contributes nondepreciable property with a fair market value of $100 and an adjusted tax basis of $150. B contributes $100 cash. A sells its partnership interest to T for $100. PRS has an election in effect to adjust the basis of partnership property under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the property. The partnership then sells the property for $120. The partnership recognizes a $20 book gain and a $30 tax loss. The book gain will be allocated equally between the partners. The entire $30 tax loss will be allocated to T under the principles of section 704(c). To match its $10 share of book gain, B will be allocated $10 of remedial gain, and T will be allocated an offsetting $10 of remedial loss. T was allocated a total of $40 of tax loss with respect to the property. However, because T has a negative $50 basis adjustment to the property, T recognizes a $10 gain from the partnership's sale of the property.

(4) *Effect of basis adjustment in determining items of deduction* -

(i) *Increases* -

(A) *Additional deduction.* The amount of any positive basis adjustment that is recovered by the transferee in any year is added to the transferee'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 basis adjustment.

(B) *Recovery period* -

(*1*) *In general.* Except as provided in paragraph (j)(4)(i)(B)(*2*) of this section, for purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer 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. The partnership is allowed to deduct the additional first year depreciation under section 168(k) and § 1.168(k)-2 for an increase in the basis of qualified property, as defined in section 168(k) and § 1.168(k)-2, under section 743(b) in a class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), even if the partnership made the election under section 168(k)(7) and § 1.168(k)-2(f)(1) not to deduct the additional first year depreciation for all other qualified property of the partnership in the same class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), and placed in service in the same taxable year, provided the section 743(b) basis adjustment meets all requirements of section 168(k) and § 1.168(k)-2. Further, the partnership may make an election under section 168(k)(7) and § 1.168(k)-2(f)(1) not to deduct the additional first year depreciation for an increase in the basis of qualified property, as defined in section 168(k) and § 1.168(k)-2, under section 743(b) in a class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), and placed in service in the same taxable year, even if the partnership does not make that election for all other qualified property of the partnership in the same class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), and placed in service in the same taxable year. In this case, the section 743(b) basis adjustment must be recovered under a reasonable method.

(*2*) *Remedial allocation method.* If a partnership elects to use the remedial allocation method described in § 1.704-3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of § 1.704-3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(*1*) of this section. The first sentence of this paragraph (j)(4)(i)(B)(*2*) does not apply to a partnership that is not a publicly traded partnership within the meaning of section 7704(b) with respect to any basis increase under section 743(b) that is recovered using the additional first year depreciation deduction under section 168(k).

(C) *Examples.* The provisions of this paragraph (j)(4)(i) are illustrated by the following examples:

Example 1.

(i) A, B, and C are equal partners in partnership PRS, which owns Asset 1, an item of depreciable property that has a fair market value in excess of its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, increases the basis of Asset 1 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 1 is $1,000. Also assume that, under paragraph (j)(4)(i)(B) of this section, the amount of the basis adjustment under section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 1 reported by T is equal to $1,500.

Example 2.

(i) A and B form equal partnership PRS. A contributes property with an adjusted basis of $100,000 and a fair market value of $500,000. B contributes $500,000 cash. When PRS is formed, the property has five years remaining in its recovery period. The partnership's adjusted basis of $100,000 will, therefore, be recovered over the five years remaining in the property's recovery period. PRS elects to use the remedial allocation method under § 1.704-3(d) with respect to the property. If PRS had purchased the property at the time of the partnership's formation, the basis of the property would have been recovered over a 10-year period. The $400,000 of section 704(c) built-in gain will, therefore, be amortized under § 1.704-3(d) over a 10-year period beginning at the time of the partnership's formation.

(ii)(A) Except for the depreciation deductions, PRS's expenses equal its income in each year of the first two years commencing with the year the partnership is formed. After two years, A's share of the adjusted basis of partnership property is $120,000, while B's is $440,000:

	Capital accounts			
	A		**B**	
	Book	**Tax**	**Book**	**Tax**
Initial Contribution	$500,000	$100,000	$500,000	$500,000
Depreciation Year 1	(30,000)		(30,000)	(20,000)
Remedial		10,000		(10,000)
	470,000	110,000	470,000	470,000
Depreciation Year 2	(30,000)		(30,000)	(20,000)
Remedial		10,000		(10,000)
	440,000	120,000	440,000	440,000

(B) A sells its interest in PRS to T for its fair market value of $440,000. A valid election under section 754 is in effect with respect to the sale of the partnership interest. Accordingly, PRS makes an adjustment, pursuant to section 743(b), to increase the basis of partnership property. Under section 743(b), the amount of the basis adjustment is equal to $320,000. Under section 755, the entire basis adjustment is allocated to the property.

(iii) At the time of the transfer, $320,000 of section 704(c) built-in gain from the property was still reflected on the partnership's books, and all of the basis adjustment is attributable to section 704(c) built-in gain. Therefore, the basis adjustment will be recovered over the remaining recovery period for the section 704(c) built-in gain under § 1.704-3(d).

(ii) *Decreases* -

(A) *Reduced deduction.* The amount of any negative basis adjustment allocated to an item of depreciable or amortizable property that is recovered in any year first decreases the transferee's distributive share of the partnership's depreciation or amortization deductions from that item of property for the year. If the amount of the basis adjustment recovered in any year exceeds the transferee's distributive share of the partnership's depreciation or amortization deductions from the item of property, then the transferee's distributive share of the partnership's depreciation or amortization deductions from other items of partnership property is decreased. The transferee then recognizes ordinary income to the extent of the excess, if any, of the amount of the basis adjustment recovered in any year over the transferee's distributive share of the partnership's depreciation or amortization deductions from all items of property.

(B) *Recovery period.* For purposes of section 168, if the basis of an item of a partnership's recovery property is decreased as the result of the transfer of an interest in the partnership, then the decrease is recovered over the remaining useful life of the item of the partnership's recovery property. The portion of the decrease that is recovered in any year during the recovery period is equal to the product of -

(*1*) The amount of the decrease to the item's adjusted basis (determined as of the date of the transfer); multiplied by

(*2*) A fraction, the numerator of which is the portion of the adjusted basis of the item recovered by the partnership in that year, and the denominator of which is the adjusted basis of the item on the date of the transfer (determined prior to any basis adjustments).

(C) *Examples.* The provisions of this paragraph (j)(4)(ii) are illustrated by the following examples:

Example 1.

(i) A, B, and C are equal partners in partnership PRS, which owns Asset 2, an item of depreciable property that has a fair market value that is less than its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, decreases the basis of Asset 2 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 2 is $1,000. Also assume that, under paragraph (j)(4)(ii)(B) of this section, the amount of the basis adjustment under section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 2 reported by T is equal to $500.

Example 2.

(i) A and B form equal partnership PRS. A contributes property with an adjusted basis of $100,000 and a fair market value of $50,000. B contributes $50,000 cash. When PRS is formed, the property has five years remaining in its recovery period. The partnership's adjusted basis of $100,000 will, therefore, be recovered over the five years remaining in the property's recovery period. PRS uses the traditional allocation method under § 1.704-3(b) with respect to the property. As a result, B will receive $5,000 of depreciation deductions from the property in each of years 1-5, and A, as the contributing partner, will receive $15,000 of depreciation deductions in each of these years.

(ii) Except for the depreciation deductions, PRS's expenses equal its income in each of the first two years commencing with the year the partnership is formed. After two years, A's share of the adjusted basis of partnership property is $70,000, while B's is $40,000. A sells its interest in PRS to T for its fair market value of $40,000. A valid election under section 754 is in effect with respect to the sale of the partnership interest. Accordingly, PRS makes an adjustment, pursuant to section 743(b), to decrease the basis of partnership property. Under section 743(b), the amount of the adjustment is equal to ($30,000). Under section 755, the entire adjustment is allocated to the property.

(iii) The basis of the property at the time of the transfer of the partnership interest was $60,000. In each of years 3 through 5, the partnership will realize depreciation deductions of $20,000 from the property. Thus, one third of the negative basis adjustment ($10,000) will be recovered in each of years 3 through 5. Consequently, T will be allocated, for tax purposes, depreciation of $15,000 each year from the partnership and will recover $10,000 of its negative basis adjustment. Thus, T's net depreciation deduction from the partnership in each year is $5,000.

Example 3.

(i) A, B, and C are equal partners in partnership PRS, which owns Asset 2, an item of depreciable property that has a fair market value that is less than its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, decreases the basis of Asset 2 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 2 is $500. PRS allocates no other depreciation to T. Also assume that, under paragraph (j)(4)(ii)(B) of this section, the amount of the negative basis adjustment that T recovers during the year is $1,000. T will report $500 of ordinary income because the amount of the negative basis adjustment recovered during the year exceeds T's distributive share of the partnership's common basis depreciation deductions from Asset 2.

(5) *Depletion.* Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowance is determined separately for each partner, including the transferee partner, based on the partner's interest in such property. See § 1.702-1(a)(8). For partnerships that hold oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee partner (and not the partnership) must make the basis adjustments, if any, required under section 743(b) with respect to such properties. See § 1.613A-3(e)(6)(iv).

(6) *Example.* The provisions of paragraph (j)(5) of this section are illustrated by the following example:

Example.

A, B, and C each contributes $5,000 cash to form partnership PRS, which purchases a coal property for $15,000. A, B, and C have equal interests in capital and profits. C subsequently sells its partnership interest to T for $100,000 when the election under section 754 is in effect. T has a basis adjustment under section 743(b) for the coal property of $95,000 (the difference between T's basis, $100,000, and its share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as its share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to T's one-third interest which has a basis to him of $100,000 ($5,000, plus its basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the coal property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to T, the transferee partner, the cost depletion method results in a greater allowance and T will, therefore, deduct $10,000 based on cost depletion. See section 613(a).

§ 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 § 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. See § 1.460-4(k)(2)(iv)(E) for rules relating to the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting.

(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.

(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,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by 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 § 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 § 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 § 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 § 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 § 1.1250-1(f) for rules similar to those contained in § 1.1245-1(e)(3)(ii).

(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.

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

§ 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 § 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 § 1.752-2.

(3) *Related person.* Related person means a person having a relationship to a partner that is described in § 1.752-4(b).

(4) *Liability defined* -

(i) *In general.* An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation -

(A) Creates or increases the basis of any of the obligor's assets (including cash);

(B) Gives rise to an immediate deduction to the obligor; or

(C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

(ii) *Obligation.* For purposes of this paragraph and § 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.

(iii) *Other liabilities.* For obligations that are not § 1.752-1 liabilities, see §§ 1.752-6 and 1.752-7.

(iv) *Effective date.* Except as otherwise provided in § 1.752-7(k), this paragraph (a)(4) applies to liabilities that are incurred or assumed by a partnership on or after June 24, 2003.

(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.* -(1) *In general.* Except as otherwise provided in paragraph (e) of this section, a person is considered to assume a liability only to the extent that:

(i) The assuming person is personally obligated to pay the liability; and

(ii) 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 under § 1.752-2 immediately after the assumption.

(2) *Applicability date.* Paragraph (d)(1)(ii) of this section applies to liabilities incurred or assumed by a partnership on or after October 9, 2019. The rules applicable to liabilities incurred or assumed prior to October 9, 2019, are contained in § 1.752-1 in effect prior to October 9, 2019, (see 26 CFR part 1 revised as of April 1, 2019).

(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. When two or more partnerships merge or consolidate under section 708(b)(2)(A), as described in § 1.708-1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under section 752.

(g) *Example.* The following example illustrates the principles of paragraphs (b), (c), (e), and (f) of this section.

Example 1. 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).

Example 2. Merger or consolidation of partnerships holding property encumbered by liabilities.

(i) B owns a 70 percent interest in partnership T. Partnership T's sole asset is property X, which is encumbered by a $900 liability. Partnership T's adjusted basis in property X is $600, and the value of property X is $1,000. B's adjusted basis in its partnership T interest is $420. B also owns a 20 percent interest in partnership S. Partnership S's sole asset is property Y, which is encumbered by a $100 liability. Partnership S's adjusted basis in property Y is $200, the value of property Y is $1,000, and B's adjusted basis in its partnership S interest is $40.

(ii) Partnership T and partnership S merge under section 708(b)(2)(A). Under section 708(b)(2)(A) and § 1.708-1(c)(1), partnership T is considered terminated and the resulting partnership is considered a continuation of partnership S. Partnerships T and S undertake the form described in § 1.708-1(c)(3)(i) for the partnership merger. Under § 1.708-1(c)(3)(i), partnership T contributes property X and its $900 liability to partnership S in exchange for an interest in partnership S. Immediately thereafter, partnership T distributes the interests in partnership S to its partners in liquidation of their interests in partnership T. B owns a 25 percent interest in partnership S after partnership T distributes the interests in partnership S to B.

(iii) Under paragraph (f) of this section, B nets the increases and decreases in its share of partnership liabilities associated with the merger of partnership T and partnership S. Before the merger, B's share of partnership liabilities was $650 (B had a $630 share of partnership liabilities in partnership T and a $20 share of partnership liabilities in partnership S immediately before the merger). B's share of S's partnership liabilities after the merger is $250 (25 percent of S's total partnership liabilities of $1,000). Accordingly, B has a $400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a $400 distribution from partnership S under section 752(b). Because B's adjusted basis in its partnership S interest before the deemed distribution under section 752(b) is $460 ($420 + $40), B will not recognize gain under section 731. After the merger, B's adjusted basis in its partnership S interest is $60.

(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.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991, as amended by T.D. 8925, 66 FR 723, Jan. 4, 2001; T.D. 9207, 70 FR 30343, May 26, 2005; T.D. 9877, 84 FR 54022, Oct. 9, 2019]

§ 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 (k) 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 § 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 creditors'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 § 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 § 1.704-1(b)(4)(i) applies) of all the partnership's assets not taken into account in paragraph (b)(2)(i) of this section.

(3) *Obligations recognized* -

(i) *In general.* The determination of the extent to which a partner or related person has an obligation to make a payment under § 1.752-2(b)(1) is based on the facts and circumstances at the time of the determination. To the extent that the obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), § 1.752-2(b) is applied as if the obligation did not exist. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including -

(A) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;

(B) 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 as described in § 1.704-1(b)(2)(ii)(*b*)(*3*) (taking into account § 1.704-1(b)(2)(ii)(*c*)); and

(C) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.

(ii) *Special rules for bottom dollar payment obligations* -

(A) *In general* . For purposes of § 1.752-2, a bottom dollar payment obligation (as defined in paragraph (b)(3)(ii)(C) of this section) is not recognized under this paragraph (b)(3).

(B) *Exception.* If a partner or related person has a payment obligation that would be recognized under this paragraph (b)(3) (initial payment obligation) but for the effect of an indemnity, a reimbursement agreement, or a similar arrangement, such bottom dollar payment obligation is recognized under this paragraph (b)(3) if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation.

(C) *Definition of bottom dollar payment obligation* -

(*1*) *In general.* Except as provided in paragraph (b)(3)(ii)(C)(*2*) of this section, a *bottom dollar payment obligation* is a payment obligation that is the same as or similar to a payment obligation or arrangement described in this paragraph (b)(3)(ii)(C)(*1*).

(*i*) With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(*ii*) With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

(*iii*) With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(*b*)(*3*) (taking into account § 1.704-1(b)(2)(ii)(*c*)), any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.

(*iv*) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in paragraph (b)(3)(ii)(C)(*1*)(*i*), (*ii*), or (*iii*) of this section.

(*2*) *Exceptions.* A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

(*3*) *Benefited party defined.* For purposes of § 1.752-2, a *benefited party* is the person to whom a partner or related person has the payment obligation.

(D) *Disclosure of bottom dollar payment obligations.* A partnership must disclose to the Internal Revenue Service a bottom dollar payment obligation (including a bottom dollar payment obligation that is recognized under paragraph (b)(3)(ii)(B) of this section) with respect to a partnership liability on a completed Form 8275, Disclosure Statement, or successor form, attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified, that includes all of the following information:

(*1*) A caption identifying the statement as a disclosure of a bottom dollar payment obligation under section 752.

(*2*) An identification of the payment obligation with respect to which disclosure is made (including whether the obligation is a guarantee, a reimbursement, an indemnity, or an obligation to restore a deficit balance in a partner's capital account).

(*3*) The amount of the payment obligation.

(*4*) The parties to the payment obligation.

(*5*) A statement of whether the payment obligation is treated as recognized for purposes of this paragraph (b)(3).

(*6*) If the payment obligation is recognized under paragraph (b)(3)(ii)(B) of this section, the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation and, but for an indemnity, a reimbursement agreement, or a similar arrangement, the partner's or related person's initial payment obligation would have been recognized under this paragraph (b)(3).

(iii) *Special rule for indemnities and reimbursement agreements.* An indemnity, a reimbursement agreement, or a similar arrangement will be recognized under this paragraph (b)(3) only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized under this paragraph (b)(3), or would be recognized under this paragraph (b)(3) if such person were a partner or related person.

(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 (a payment obligor) actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate -

(i) A plan to circumvent or avoid the obligation under paragraph (j) of this section, or

(ii) That there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable as described in paragraph (k) of this section.

(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.

(3) [Reserved]. For further guidance, see § 1.752-2T(c)(3).

(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 of 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. Unless otherwise provided, for purposes of paragraph (f)(1) through (9) of this section (*Examples 1* through *9*), assume that any obligation of a partner or related person to make a payment is recognized under paragraph (b)(3) of this section.

(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:

	A	**B**
Initial contribution	$100	$100
Loss on hypothetical sale	(900)	(100)
	($800)	$0

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.

(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:

	C	**D**
Initial contribution	$500	$500
Loss on hypothetical sale	(4,000)	(6,000)
	($3,500)	($5,500)

C's capital account reflects a deficit that C would have to make up to $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.

(3) *Guarantee by 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:

	E	**F**
Initial contribution	$2,000	$8,000
Loss on hypothetical sale	(17,000)	(8,000)
	($15,000)	$0

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.

(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.

(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.

(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.

(7) *Guarantee of interest by partner treated as part recourse and part 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 × .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).

(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 § 1.752-3, J and K share this nonrecourse liability equally because they share all profits and losses equally.

(9) [Reserved].

(10) *Example 10. Guarantee of first and last dollars* .

(i) A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other.

(ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under § 1.752-2(b)(1) is $300.

(iii) Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under § 1.752-2(b)(1) for ABC's liability.

(iv) In sum, $300 of ABC's liability is allocated to A under § 1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under § 1.752-3.

(11) *Example 11. Indemnification of guarantees* .

(i) The facts are the same as in paragraph (f)(10) of this section (*Example 10*), except that, in addition, C agrees to indemnify A up to $100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee.

(ii) The determination of whether C's indemnity is recognized under paragraph (b)(3) of this section is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is recognized under paragraph (b)(3) of this section. The amount of C's economic risk of loss under § 1.752-2(b)(1) for its indemnity of A's guarantee is $100.

(iii) Because C's indemnity is recognized under paragraph (b)(3) of this section, A is treated as liable for $200 only to the extent any amount beyond $100 of the partnership liability is not satisfied. Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and the exception in paragraph (b)(3)(ii)(B) of this section does not apply. As a result, A's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and is not recognized under paragraph (b)(3)(ii)(A) of this section. Therefore, A bears no economic risk of loss under § 1.752-2(b)(1) for ABC's liability.

(iv) Because B's obligation is not recognized under paragraph (b)(3)(ii) of this section independent of C's indemnity of B's guarantee, C's indemnity is not recognized under paragraph (b)(3)(iii) of this section. Therefore, C bears no economic risk of loss under § 1.752-2(b)(1) for its indemnity of B's guarantee.

(v) In sum, $100 of ABC's liability is allocated to C under § 1.752-2(a) and the remaining $900 liability is allocated to A, B, and C under § 1.752-3.

(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:

	A	**B**
Initial contribution	$10,000	$10,000
Loss on hypothetical sale	(45,000)	(45,000)
	(35,000)	(35,000)

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 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 for a partnership liability 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 net fair market value of the property (pledged property) at the time of the pledge or contribution. If a partner provides additional pledged property, the addition is treated as a new pledge and the net fair market value of the pledged property (including but not limited to the additional property) must be determined at that time. For purposes of this paragraph (h), if pledged property is subject to one or more other obligations, those obligations must be taken into account in determining the net fair market value of pledged property at the time of the pledge or 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 recourse 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* -

(i) *In general* . 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 -

(A) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;

(B) The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and

(C) With respect to the contractual obligations described in paragraphs (j)(2)(i)(A) and (B) of this section -

(*1*) 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; or

(*2*) Another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation described in paragraphs (j)(2)(i)(A) and (B) of this section to be disregarded under paragraph (b)(3) of this section.

(ii) *Economic risk of loss.* For purposes of this paragraph (j)(2), partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.

(3) *Plan to circumvent or avoid an obligation* -

(i) *General rule* . An obligation of a partner or related person to make a payment is not recognized under paragraph (b) of this section if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

(ii) *Factors indicating plan to circumvent or avoid an obligation.* In the case of a payment obligation, other than an obligation to restore a deficit capital account upon liquidation of a partnership, paragraphs (j)(3)(ii)(A) through (G) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation. The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. For purposes of making determinations under this paragraph (j)(3), the weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized under paragraph (b) of this section.

(A) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

(B) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party, including, for example, balance sheets and financial statements.

(C) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonably foreseeable needs of such obligor (but not taking into account standard commercial insurance, for example, casualty insurance).

(E) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(F) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(G) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

(4) *Example.* The following example illustrates the principles of paragraph (j) of this section.

(i) In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2020. In 2022, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under paragraph (j)(3) of this section, A's 2022 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A's guarantee is not recognized under paragraph (b) of this section. As a result, LLC's liability continues to be treated as nonrecourse.

(k) *No reasonable expectation of payment* -

(1) *In general.* An obligation of any partner or related person to make a payment is not recognized under paragraph (b) of this section if the facts and circumstances indicate that at the time the partnership must determine a partner's share of partnership liabilities under §§ 1.705-1(a) and 1.752-4(d) there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable. Facts and circumstances to consider in determining a commercially reasonable expectation of payment include factors a third party creditor would take into account when determining whether to grant a loan. For purposes of this section, a payment obligor includes an entity disregarded as an entity separate from its owner under section 856(i), section 1361(b)(3), or §§ 301.7701-1 through 301.7701-3 of this chapter (a disregarded entity), and a trust to which subpart E of part I of subchapter J of chapter 1 of the Code applies.

(2) *Examples.* The following examples illustrate the principles of paragraph (k) of this section.

(i) *Example 1. Undercapitalization* .

(A) In 2020, A forms a wholly owned domestic limited liability company, LLC, with a contribution of $100,000. A has no liability for LLC's debts, and LLC has no enforceable right to a contribution from A. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC is treated for federal tax purposes as a disregarded entity. Also in 2020, LLC contributes $100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes $100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to restore any deficit in its capital account. On January 1, 2021, LP borrows $300,000 from a bank and uses $600,000 to purchase nondepreciable property. The $300,000 is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its $300,000 debt during 2021. LP has a net taxable loss in 2021, and, under §§ 1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the $300,000 debt at the end of its taxable year, December 31, 2021. As of that date, LLC holds no assets other than its interest in LP.

(B) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the $300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (k) of this section is applied to the LLC and not to A. LLC has no assets with which to pay if the payment obligation becomes due and payable. Because there is no commercially reasonable expectation that LLC will be able to satisfy its payment obligation, LLC's obligation to restore its deficit capital account is not recognized under paragraph (b) of this section. As a result, LP's $300,000 debt is characterized as nonrecourse under § 1.752-1(a)(2) and is allocated among A, B, and C under § 1.752-3.

(ii) *Example 2. Disregarded entity with ability to pay* .

(A) The facts are the same as in paragraph (k)(2)(i) of this section (*Example 1*), except LLC also holds real property worth $475,000 subject to a $200,000 liability. Additionally, LLC reasonably projects to earn $20,000 of net rental income per year from such real property.

(B) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the $300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (k) of this section is applied to the LLC and not to A. Because there is a commercially reasonable expectation that LLC will be able to satisfy its payment obligation, LLC's obligation to restore its deficit capital account is recognized under paragraph (b) of this section. As a result, LP's $300,000 debt is characterized as recourse under § 1.752-1(a)(1) and is allocated to A under § 1.752-2.

(l) *Applicability dates.*

(1) Paragraphs (a) and (h)(3) of this section apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. The rules applicable to liabilities incurred or assumed (or pursuant to a written binding contract in effect) prior to October 11, 2006, are contained in § 1.752-2 in effect prior to October 11, 2006, (see 26 CFR part 1 revised as of April 1, 2006). Paragraphs (b)(6), (j)(3) and (4), and (k) of this section apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after October 9, 2019, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. However, taxpayers may apply paragraphs (b)(6), (j)(3) and (4), and (k) of this section to all of their liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016. The rules applicable to liabilities incurred or assumed (or pursuant to a written binding contract in effect) prior to October 9, 2019, are contained in § 1.752-2 in effect prior to October 9, 2019, (see 26 CFR part 1 revised as of April 1, 2019).

(2) Paragraphs (b)(3), (f)(10) and (11), and (j)(2) of this section apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. Partnerships may apply paragraphs (b)(3), (f)(10) and (11), and (j)(2) of this section to all of their liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016. The rules applicable to liabilities incurred or assumed (or subject to a written binding contract in effect) prior to October 5, 2016, are contained in § 1.752-2 in effect prior to October 5, 2016, (see 26 CFR part 1 revised as of April 1, 2016).

(3) If a partner has a share of a recourse partnership liability under § 1.752-2(a) as a result of bearing the economic risk of loss under § 1.752-2(b) immediately prior to October 5, 2016 (Transition Partner), and such liability is modified or refinanced, the partnership (Transition Partnership) may choose not to apply paragraphs (b)(3), (f)(10) and (11), and (j)(2)(i)(C)(*2*) of this section to the extent the amount of the Transition Partner's share of liabilities under § 1.752-2(a) as a result of bearing the economic risk of loss under § 1.752-2(b) immediately prior to October 5, 2016, exceeds the amount of the Transition Partner's adjusted basis in its partnership interest as determined under § 1.705-1 at such time (Grandfathered Amount). See also § 1.704-2(g)(3). A liability is modified or refinanced for purposes of this paragraph (l) to the extent that the proceeds of a partnership liability (the refinancing debt) are allocable under the rules of § 1.163-8T to payments discharging all or part of any other liability (pre-modification liability) of that partnership or there is a significant modification of that liability as provided under § 1.1001-3. A Transition Partner that is a partnership, S corporation, or a business entity disregarded as an entity separate from its owner under section 856(i) or 1361(b)(3) or §§ 301.7701-1 through 301.7701-3 of this chapter ceases to qualify as a Transition Partner if the direct or indirect ownership of that Transition Partner changes by 50 percent or more. The Transition Partnership may continue to apply the rules under § 1.752-2 in effect prior to October 5, 2016, with respect to a Transition Partner for payment obligations described in § 1.752-2(b) to the extent of the Transition Partner's adjusted Grandfathered Amount for the seven-year period beginning October 5, 2016. The termination of a Transition Partnership under section 708(b)(1)(B) and applicable regulations prior to January 1, 2018, does not affect the Grandfathered Amount of a Transition Partner that remains a partner in the new partnership (as described in § 1.708-1(b)(4)), and the new partnership is treated as a continuation of the Transition Partnership for purposes of this paragraph (l)(3). However, a Transition Partner's Grandfathered Amount is reduced (not below zero), but never increased by -

(i) Upon the sale of any property by the Transition Partnership, an amount equal to the excess of any gain allocated for federal income tax purposes to the Transition Partner by the Transition Partnership (including amounts allocated under section 704(c) and applicable regulations) over the product of the total amount realized by the Transition Partnership from the property sale multiplied by the Transition Partner's percentage interest in the partnership; and

(ii) An amount equal to any decrease in the Transition Partner's share of liabilities to which the rules of this paragraph (l)(3) apply, other than by operation of paragraph (l)(3)(i) of this section.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991; 57 FR 4913, Feb. 10, 1992; 57 FR 5054, Feb. 12, 1992; 57 FR 5511, Feb. 14, 1992; T.D. 9289, 71 FR 59672, Oct. 11, 2006; T.D. 9788, 81 FR 69288, Oct. 5, 2016; T.D. 9790, 81 FR 72984, Oct. 21, 2016; T.D. 9877, 84 FR 54023, Oct. 9, 2019]

§ 1.752-3 Partner's share of nonrecourse 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 (significant item method). 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 (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property (additional method). The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2). This additional method does not apply for purposes of § 1.707-5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

(b) *Allocation of a single nonrecourse liability among multiple properties* -

(1) *In general.* For purposes of determining the amount of taxable gain under paragraph (a)(2) of this section, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this

paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

(2) *Reductions in principal.* For purposes of this paragraph (b), when the outstanding principal of a partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under paragraph (b)(1) of this section.

(c) *Examples.* The following examples illustrate the principles 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 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 regulation 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.

Example 3. Allocation of liability among multiple properties.

(i) A and B are equal partners in a partnership (PRS). A contributes $70 of cash in exchange for a 50-percent interest in PRS. B contributes two items of property, X and Y, in exchange for a 50-percent interest in PRS. Property X has a fair market value (and book value) of $70 and an adjusted basis of $40, and is subject to a nonrecourse liability of $50. Property Y has a fair market value (and book value) of $120, an adjusted basis of $40, and is subject to a nonrecourse liability of $70. Immediately after the initial contributions, PRS refinances the two separate liabilities with a single $120 nonrecourse liability. All of the built-in gain attributable to Property X ($30) and Property Y ($80) is section 704(c) gain allocable to B.

(ii) The amount of the nonrecourse liability ($120) is less than the total book value of all of the properties that are subject to such liability ($70 + $120 = $190), so there is no partnership minimum gain. § 1.704-2(d). Accordingly, no portion of the liability is allocated pursuant to paragraph (a)(1) of this section.

(iii) Pursuant to paragraph (b)(1) of this section, PRS decides to allocate the nonrecourse liability evenly between the Properties X and Y. Accordingly, each of Properties X and Y are treated as being subject to a separate $60 nonrecourse liability for purposes of applying paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B will be allocated $20 of the liability for each of Properties X and Y (in each case, $60 liability minus $40 adjusted basis). As a result, a portion of the liability is allocated pursuant to paragraph (a)(2) of this section as follows:

Partner	Property	Tier 1	Tier 2
A	X	$0	$0
	Y	0	0
B	X	0	20
	Y	0	20

(iv) PRS has $80 of excess nonrecourse liability that it may allocate in any manner consistent with paragraph (a)(3) of this section. PRS determines to allocate the $80 of excess nonrecourse liabilities to the partners up to their share of the remaining section 704(c) gain on the properties, with any remaining amount of liabilities being allocated equally to A and B consistent with their equal interests in partnership profits. B has $70 of remaining section 704(c) gain ($10 on Property X and $60 on Property Y), and thus will be allocated $70 of the liability in accordance with this gain.

The remaining $10 is divided equally between A and B. Accordingly, the overall allocation of the $120 nonrecourse liability is as follows:

Partner	Tier 1	Tier 2	Tier 3	Total
A	$0	$0	$5	$5
B	0	40	75	115

(d) *Effective/applicability dates.* The third, fourth, fifth, and sixth sentences of paragraph (a)(3) of this section apply to liabilities that are incurred, taken subject to, or assumed by a partnership on or after October 5, 2016, other than liabilities incurred, taken subject to, or assumed by a partnership pursuant to a written binding contract in effect prior to October 5, 2016. For liabilities that are incurred, taken subject to, or assumed by a partnership before October 5, 2016, the third, fourth, fifth, and sixth sentences of paragraph (a)(3) of this section as contained in 26 CFR part 1 revised as of April 1, 2016, apply.

[T.D. 8380, 56 FR 66355, Dec. 23, 1991, as amended by T.D. 8906, 65 FR 64890, Oct. 31, 2000; T.D. 9787, 81 FR 69300, Oct. 5, 2016]

§ 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 section 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 §§ 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 § 1.705-1(a) for rules regarding when the adjusted basis of a partner's interest in the partnership must be determined.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991]

§ 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 § 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 paragraph (b)(1) must set forth the name and address of the partnership making the election and 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 § 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 § 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.

§ 1.755-1 Rules for allocation of basis.

(a) *In general* -

(1) *Scope.* This section provides rules for allocating basis adjustments under sections 743(b) and 734(b) among partnership property. If there is a basis adjustment to which this section applies, the basis adjustment is allocated among the partnership's assets as follows. First, the partnership must determine the value of each of its assets under paragraphs (a)(2) through (5) of this section. Second, the basis adjustment is 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. Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class. Basis adjustments under section 743(b) are allocated among partnership assets under paragraph (b) of this section. Basis adjustments under section 734(b) are allocated among partnership assets under paragraph (c) of this section.

(2) *Coordination of sections 755 and 1060.* If there is a basis adjustment to which this section applies, and the assets of the partnership constitute a trade or business (as described in § 1.1060-1(b)(2)), then the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles. To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term *section 197 intangibles* includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

(3) *Values of properties other than section 197 intangibles.* For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

(4) *Partnership gross value* -

(i) *Basis adjustments under section 743(b)* -

(A) *In general.* Except as provided in paragraph (a)(4)(ii) of this section, in the case of a basis adjustment under section 743(b), partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).

(B) *Special situations.* In certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles held by the partnership. In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

(C) *Income in respect of a decedent.* Solely for the purpose of determining partnership gross value under this paragraph (a)(4)(i), where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to section 1014(c) or section 1022(f), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691.

(ii) *Basis adjustments under section 743(b) resulting from substituted basis transactions.* This paragraph (a)(4)(ii) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

(iii) *Basis adjustments under section 734(b).* In the case of a basis adjustment under section 734(b), partnership gross value equals the value of the entire partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution.

(5) *Determining the values of section 197 intangibles* -

(i) *Two classes.* If the aggregate value of partnership property other than section 197 intangibles (as determined in paragraph (a)(3) of this section) is equal to or greater than partnership gross value (as determined in paragraph (a)(4) of this section), then all section 197 intangibles are deemed to have a value of zero for purposes of this section. In all other cases, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles. The residual section 197 intangibles value must be allocated between two asset classes in the following order -

(A) Among section 197 intangibles other than goodwill and going concern value; and

(B) To goodwill and going concern value.

(ii) *Values assigned to section 197 intangibles other than goodwill and going concern value.* The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

(iii) *Value assigned to goodwill and going concern value.* The fair market value of goodwill and going concern value is the amount, if any, by which the residual section 197 intangibles value exceeds the aggregate value of the partnership's section 197 intangibles (other than goodwill and going concern value).

(6) *Examples.* The provisions of paragraphs (a)(2) through (5) are illustrated by the following examples, which assume that the partnerships have an election in effect under section 754 at the time of the transfer and that the assets of each partnership constitute a trade or business (as described in § 1.1060-1(b)(2)). Except as provided, no partnership asset (other than inventory) is property described in section 751(a), and partnership liabilities are secured by all partnership assets. The examples are as follows:

Example 1.

(i) A is the sole general partner in PRS, a limited partnership having three equal partners. PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two other assets with fair market values (determined using all the facts and circumstances) as follows: inventory worth $1,000,000 and a building (a capital asset) worth $2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is $50,000. PRS has one liability of $1,000,000, for which A bears the entire risk of loss under section 752 and the regulations thereunder. D purchases A's partnership interest for $650,000, resulting in a basis adjustment under section 743(b). After the purchase, D bears the entire risk of loss for PRS's liability under section 752 and the regulations thereunder. Therefore, D's basis in its interest in PRS is $1,650,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $650,000 ($1,650,000 - $1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $2,950,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $650,000).

(iii) Under paragraph (a)(3) of this section, the inventory has a fair market value of $1,000,000, and the building has a fair market value of $2,000,000. Thus, the aggregate value of partnership property other than section 197 intangibles, $3,000,000, is equal to or greater than partnership gross value, $2,950,000. Accordingly, under paragraphs (a)(3) and (5) of this section, the value assigned to each of the partnership's assets is as follows: inventory, $1,000,000; building, $2,000,000; Intangibles 1 and 2, $0; and goodwill and going concern value, $0. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 2.

(i) Assume the same facts as in *Example 1,* except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that D purchases A's interest in PRS for $1,000,000. After the purchase, D's basis in its interest in PRS is $2,000,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $1,000,000 ($2,000,000 - $1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $4,000,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $1,000,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $1,000,000 (the excess of partnership gross value, $4,000,000, over the aggregate value of assets other than section 197 intangibles, $3,000,000 (the sum of the value of the inventory, $1,000,000, and the value of the building, $2,000,000)). The partnership must determine the values of section 197 assets by allocating the residual section 197 intangibles value among the partnership's assets. The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 3.

(i) Assume the same facts as in *Example 1,* except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that D purchases A's interest in PRS for $750,000. After the purchase, D's basis in its interest in PRS is $1,750,000. Also assume that Intangible 1 was originally purchased for $300,000, and that its adjusted basis has been decreased to $50,000 as a result of amortization. Assume that, if PRS were to sell Intangible 1 for $300,000, it would recognize $250,000 of gain that would be treated as an unrealized receivable under the flush language in section 751(c).

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $750,000 ($1,750,000 - $1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $3,250,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $750,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $250,000 (the amount by which partnership gross value, $3,250,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $3,000,000). Intangible 1 has potential gain that would be treated as unrealized receivables under the flush language of section 751(c). The flush language receivables value in Intangible 1 is $300,000 (the sum of PRS's basis in Intangible 1, $50,000, and the amount of ordinary income, $250,000, that the partnership would recognize if Intangible 1 were sold for its actual fair market value). Because the residual section 197 intangibles value, $250,000, is less than the flush language receivables value of Intangible 1, Intangible 1 is assigned a value of $250,000, and Intangible 2 and goodwill and going concern value are assigned a value of zero. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 4.

Assume the same facts as in *Example 1,* except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that A does not sell its interest in PRS. Instead, A contributes its interest in PRS to E, a newly formed corporation wholly-owned by A, in a transaction described in section 351. Assume that the contribution results in a basis adjustment under section 743(b) (other than zero). PRS determines that its value as a going concern immediately following the contribution is $3,000,000. Under paragraph (a)(4)(ii) of this section, partnership gross value is $4,000,000 (the value of PRS as a going concern, $3,000,000, increased by the partnership's liability, $1,000,000, immediately after the contribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $1,000,000 (the amount by which partnership gross value, $4,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $3,000,000). Of the residual section 197 intangibles value, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). E's section 743(b) adjustment must be allocated under paragraph (b)(5) of this section using these assigned fair market values.

Example 5.

G is the sole general partner in PRS, a limited partnership having three equal partners (G, H, and I). PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two capital assets with fair market values (determined using all the facts and circumstances) as follows: Vacant land worth $1,000,000, and a building worth $2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is $300,000. PRS has one liability of $1,000,000, for which G bears the entire risk of loss under section 752 and the regulations thereunder. PRS distributes the land to H in liquidation of H's interest in PRS. Immediately prior to the distribution, PRS's basis in the land is $800,000, and H's basis in its interest in PRS is $750,000. The distribution causes the partnership to increase the basis of its remaining property by $50,000 under section 734(b)(1)(B). PRS determines that its value as a going concern immediately following the distribution is $2,000,000. Under paragraph (a)(4)(iii) of this section, partnership gross value is $3,000,000 (the value of PRS as a going concern, $2,000,000, increased by the partnership's liability, $1,000,000, immediately after the distribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value of PRS's section 197 intangibles is $1,000,000 (the amount by which partnership gross value, $3,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $2,000,000). Of the residual section 197 intangibles value, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). PRS's section 734(b) adjustment must be allocated under paragraph (c) of this section using these assigned fair market values.

(b) *Adjustments under section 743(b)* -

(1) *Generally.*

(i) *Application.* For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply. For transfers subject to section 334(b)(1)(B), see § 1.334-1(b)(3)(iii)(C)(*1*) (treating a determination of basis under § 1.334-1(b)(3) as a determination not by reference to the transferor's basis solely for purposes of applying section 755); for transfers subject to section 362(e)(1), see § 1.362-3(b)(4)(i) (treating a determination of basis under § 1.362-3 as a determination not by reference to the transferor's basis solely for purposes of applying section 755); for transfers subject to section 362(e)(2), see § 1.362-4(c)(3)(i) (treating a determination of basis under § 1.362-4 as a determination by reference to the transferor's basis for all purposes). 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 § 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). See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of 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 § 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 § 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:

	Assets	
	Adjusted basis	**Fair market value**
Capital Gain Property:		
Asset 1	$25,000	$75,000
Asset 2	100,000	117,500
Ordinary Income Property:		
Asset 3	40,000	45,000
Asset 4	10,000	2,500
Total	175,000	240,000

(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:

	Assets	
	Adjusted basis	**Fair market value**
Capital Gain Property:		
Asset 1	$500	$750
Asset 2	500	500
Ordinary Income Property:		
Asset 3	500	250
Asset 4	500	500
Total	2,000	2,000

(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 § 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; reduced by

(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 § 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 § 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) *Special rules* -

(A) *Assets in which partner has no interest.* An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in applying paragraph (b)(3)(ii)(B) of this section.

(B) *Limitation in decrease of basis.* In no event may the amount of any decrease in basis allocated to an item of capital gain property under paragraph (b)(3)(ii)(B) of this section exceed the partnership's adjusted basis in that item (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under § 1.704-3(d) from the hypothetical transaction). In the event that a decrease in basis allocated under paragraph (b)(3)(ii)(B) of this section to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under this paragraph (b)(3)).

(iv) *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 × $75,000/$192,500)). The amount of the basis adjustment to Asset 2 is $2,646 ($8,750 minus $6,104 ($10,000 × $117,500/$192,500)).

(4) *Income in respect of a decedent* -

(i) *In general.* Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) or section 1022(f), the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691. See § 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 § 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. In 2004, 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 (based on all the facts and circumstances):

Assets

	Adjusted basis	**Fair market value**
Section 197 Intangible	$2,000	$5,000
Unrealized Receivables	0	15,000
Total	$2,000	$20,000
Liabilities and Capital		
	Adjusted per books	Fair market value
Capital:		
A	1,000	10,000
B	1,000	10,000
Total	$2,000	$20,000

(ii) None of the assets owned by PRS is section 704(c) property, and the section 197 intangible is not amortizable. 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 50% share of the partnership's section 197 intangible, 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) Under paragraph (a)(4)(i)(C) of this section, solely for purposes of determining partnership gross value, T's basis in its partnership interest is deemed to be $10,000. Under paragraph (a)(4)(i) of this section, partnership gross value is $20,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to T equal to $10,000).

(iv) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $5,000 (the excess of partnership gross value, $20,000, over the aggregate value of assets other than section 197 intangibles, $15,000). The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, $5,000 is assigned to the section 197 intangible, and $0 is assigned to goodwill and going concern value. T's section 743(b) adjustment must be allocated using these assigned fair market values.

(v) 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 section 197 intangible.

(5) *Substituted basis transactions* -

(i) *In general.* This paragraph (b)(5) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest. For exchanges on or after June 9, 2003, this paragraph (b)(5) also applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. For example, this paragraph (b)(5) applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies, if a partnership interest is contributed to a partnership in a transaction to which section 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which section 731(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 § 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 § 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 substituted basis transaction, 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	
	Adjusted basis	**Fair market value**
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Nondepreciable capital asset	20,000	40,000
Total	55,000	76,000

	Liabilities and Capital	
	Adjusted per books	**Fair market value**
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

(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 this 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) *Cross reference.* See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of unrealized appreciation or depreciation in a contract accounted for under a long-term contract method of accounting.

(6) *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, nondepreciable 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 2 and 3 are nondepreciable capital assets, and Assets 4, 5, and 6 are inventory that has not appreciated substantially in value within the meaning of section 751(b)(3). Assets 4, 5, and 6 are the only assets held by the partnership that 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:

	Assets	
	Adjusted basis	**Fair market value**
Capital Gain Property:		
Asset 1	$ 25,000	$ 75,000
Asset 2	100,000	117,500
Asset 3	50,000	60,000
Ordinary Income Property:		

	Assets	
	Adjusted basis	**Fair market value**
Asset 4	40,000	45,000
Asset 5	50,000	60,000
Asset 6	10,000	2,500
Total	275,000	360,000

(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).

§ 1.761-1 Terms defined.

(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.

§ 1.1223-3 Rules relating to the holding periods of partnership interests.

(a) *In general.* A partner shall not have a divided holding period in an interest in a partnership unless -

(1) The partner acquired portions of an interest at different times; or

(2) The partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods (*e.g.,* section 1223).

(b) *Accounting for holding periods of an interest in a partnership* -

(1) *General rule.* The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the

denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

(2) *Special rule.* For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged (or with respect to which gain or loss is recognized upon a distribution under section 731), if a partner makes one or more contributions of cash to the partnership and receives one or more distributions of cash from the partnership during the one-year period ending on the date of the sale or exchange (or distribution with respect to which gain or loss is recognized under section 731), the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received immediately before the sale or exchange (or at the time of the distribution with respect to which gain or loss is recognized under section 731).

(3) *Deemed contributions and distributions.* For purposes of paragraphs (b)(1) and (2) of this section, deemed contributions of cash under section 752(a) and deemed distributions of cash under section 752(b) shall be disregarded to the same extent that such amounts are disregarded under § 1.704-1(b)(2)(iv)(c).

(4) *Adjustment with respect to contributed section 751 assets.* For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged, if a partner receives a portion of the partnership interest in exchange for property described in section 751(c) or (d) (section 751 assets) within the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, and the partner recognizes ordinary income or loss on account of such a section 751 asset in a fully taxable transaction (either as a result of the sale of all or part of the partner's interest in the partnership or the sale by the partnership of the section 751 asset), the contribution of the section 751 asset during the one-year period shall be disregarded. However, if, in the absence of this paragraph, a partner would not be treated as having held any portion of the interest for more than one year (*e.g.,* because the partner's only contributions to the partnership are contributions of section 751 assets or section 751 assets and cash within the prior one-year period), this adjustment is not available.

(5) *Divided holding period if partnership interest comprises in whole or in part one or more profits interests* -

(i) *In general.* If a partnership interest is comprised in whole or in part of one or more profits interests (as defined in paragraph (b)(5)(ii) of this section), then, for purposes of applying paragraph (b)(1) of this section, the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest upon the disposition of all, or part, of the interest (and not at the time that the profits interest is acquired). Paragraph (b)(1) of this section continues to apply to the extent that a partner acquires portions of a partnership interest that are not comprised of a profits interest and the value of the profits interest is not included for purposes of determining the value of the entire partnership interest under paragraph (b)(1).

(ii) *Definition of capital interest and profits interest.* For purposes of this paragraph (b)(5), a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and then the proceeds were distributed in a complete liquidation of the partnership. A profits interest, for purposes of this paragraph (b)(5), is received in connection with the performance of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, and the receipt of the interest is not treated as a taxable event for the partner or the partnership under applicable Federal income tax guidance.

(6) *Exception.* The Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) a rule disregarding certain cash contributions (including

contributions of a de minimis amount of cash) in applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged.

§ 1.1245-4 Exceptions and limitations.

(f) *Limitation for property distributed by a partnership* -

(1) *In general.* For purposes of section 1245(b)(3) (relating to certain tax-free transactions), the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(2) *Adjustments reflected in the adjusted basis.* If section 1245 property is distributed by a partnership to a partner, then, for purposes of determining the recomputed basis of the property in the hands of the distributee, the amount of the adjustments reflected in the adjusted basis of the property immediately after the distribution shall be an amount equal to:

(i) The potential section 1245 income (as defined in paragraph (c)(4) of § 1.751-1) of the partnership in respect of the property immediately before the distribution, reduced by

(ii) The portion of such potential section 1245 income which is recognized as ordinary income to the partnership under paragraph (b)(2)(ii) of § 1.751-1.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1.

(i) A machine, which is section 1245 property owned by partnership ABC, has an adjusted basis of $9,000, a recomputed basis of $18,000, and a fair market value of $15,000. Since the fair market value of the machine is lower than its recomputed basis, the potential section 1245 income in respect of the machine is the excess of fair market value over adjusted basis, or $6,000. The partnership distributes the machine to C in a complete liquidation of his partnership interest to which section 736(a) does not apply. C, who had originally contributed the machine to the partnership, has a basis for his partnership interest of $10,000. Since section 751(b)(2)(A) provides that section 751(b)(1) does not apply to a distribution of property to the partner who contributed the property, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1245). By reason of the application of section 731, C's basis for the property would, under section 732(b), be equal to his basis for his interest in the partnership, or $10,000.

(ii) Since section 731 applies to the distribution, and since subparagraph (1) of this paragraph provides that, for purposes of section 1245(b)(3), C's basis for the property is deemed to be determined by reference to the adjusted basis of the property to the partnership, the gain taken into account under section 1245(a)(1) by the partnership is limited by section 1245(b)(3) so as not to exceed the amount of gain which would be recognized to the partnership if section 1245 did not apply. Accordingly, the partnership does not recognize any gain under section 1245(a)(1) upon the distribution.

(iii) Immediately after the distribution, the amount of the adjustments reflected in the adjusted basis of the property is equal to $6,000 (that is, the potential section 1245 income of the partnership in respect of the property before the distribution, $6,000, minus the gain recognized by the partnership under section 751(b), zero). Accordingly, C's recomputed basis for the property is $16,000 (that is, adjusted basis, $10,000, plus adjustments reflected in the adjusted basis, $6,000).

Example 2.

Assume the same facts as in example (1) except that the machine had been purchased by the partnership. Assume further that upon the distribution, the partnership recognizes $4,000 gain as ordinary income under section 751(b). Under section 1245(b)(3), gain to be taken into account under section 1245(a)(1) by the partnership is limited to $4,000. Immediately after the distribution, the amount of adjustments reflected in the adjusted basis of the property is $2,000 (that is, potential section 1245 income of the partnership, $6,000, minus gain recognized to the partnership under section 751(b), $4,000). Thus, if the adjusted basis of the machine in the hands of C were $11,333 (see, for example, the computation in paragraph (d)(2) of example (6) of paragraph (g) of § 1.751-1), the recomputed basis of the machine would be $13,333 ($11,333 plus $2,000).

§ 301.7701-1 Classification of organizations for federal tax purposes.

(a) *Organizations for federal tax purposes* -

(1) *In general.* The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) *Certain joint undertakings give rise to entities for federal tax purposes.* A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co- owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(3) *Certain local law entities not recognized.* An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. 503, are not recognized as separate entities for federal tax purposes.

(4) *Single owner organizations.* Under §§ 301.7701-2 and 301.7701-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

§ 301.7701-2 Business entities; definitions.

(a) *Business entities.* For purposes of this section and § 301.7701-3, a *business entity* is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. But see paragraphs (c)(2)(iii) through (vi) of this section for special rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

(b) *Corporations.* For federal tax purposes, the term *corporation* means -

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under § 301.7701-3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 *et seq.,* or a similar federal statute;

(6) A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in § 1.892-2T;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

(8) *Certain foreign entities* -

(i) *In general.* Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation

Argentina, Sociedad Anonima

Australia, Public Limited Company

Austria, Aktiengesellschaft

Barbados, Limited Company

Belgium, Societe Anonyme

Belize, Public Limited Company

Bolivia, Sociedad Anonima

Brazil, Sociedade Anonima

Bulgaria, Aktsionerno Druzhestvo.

Canada, Corporation and Company

Chile, Sociedad Anonima

People's Republic of China, Gufen Youxian Gongsi

Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu

Colombia, Sociedad Anonima

Costa Rica, Sociedad Anonima

Cyprus, Public Limited Company

Czech Republic, Akciova Spolecnost

Denmark, Aktieselskab

Ecuador, Sociedad Anonima or Compania Anonima

Egypt, Sharikat Al-Mossahamah

El Salvador, Sociedad Anonima

Estonia, Aktsiaselts

European Economic Area/European Union, Societas Europaea

Finland, Julkinen Osakeyhtio/Publikt Aktiebolag

France, Societe Anonyme

Germany, Aktiengesellschaft

Greece, Anonymos Etairia

Guam, Corporation

Guatemala, Sociedad Anonima

Guyana, Public Limited Company

Honduras, Sociedad Anonima

Hong Kong, Public Limited Company

Hungary, Reszvenytarsasag

Iceland, Hlutafelag

India, Public Limited Company

Indonesia, Perseroan Terbuka

Ireland, Public Limited Company

Israel, Public Limited Company

Italy, Societa per Azioni

Jamaica, Public Limited Company

Japan, Kabushiki Kaisha

Kazakstan, Ashyk Aktsionerlik Kogham

Republic of Korea, Chusik Hoesa

Latvia, Akciju Sabiedriba

Liberia, Corporation

Liechtenstein, Aktiengesellschaft

Lithuania, Akcine Bendroves

Luxembourg, Societe Anonyme

Malaysia, Berhad

Malta, Public Limited Company

Mexico, Sociedad Anonima

Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap

New Zealand, Limited Company

Nicaragua, Compania Anonima

Nigeria, Public Limited Company

Northern Mariana Islands, Corporation

Norway, Allment Aksjeselskap

Pakistan, Public Limited Company

Panama, Sociedad Anonima

Paraguay, Sociedad Anonima

Peru, Sociedad Anonima

Philippines, Stock Corporation

Poland, Spolka Akcyjna

Portugal, Sociedade Anonima

Puerto Rico, Corporation

Romania, Societate pe Actiuni

Russia, Otkrytoye Aktsionernoy Obshchestvo

Saudi Arabia, Sharikat Al-Mossahamah

Singapore, Public Limited Company

Slovak Republic, Akciova Spolocnost

Slovenia, Delniska Druzba

South Africa, Public Limited Company

Spain, Sociedad Anonima

Surinam, Naamloze Vennootschap

Sweden, Publika Aktiebolag

Switzerland, Aktiengesellschaft

Thailand, Borisat Chamkad (Mahachon)

Trinidad and Tobago, Limited Company

Tunisia, Societe Anonyme

Turkey, Anonim Sirket

Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu

United Kingdom, Public Limited Company

United States Virgin Islands, Corporation

Uruguay, Sociedad Anonima

Venezuela, Sociedad Anonima or Compania Anonima

(ii) *Clarification of list of corporations in paragraph (b)(8)(i) of this section* -

(A) *Exceptions in certain cases.* The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(*1*) With regard to Canada, a Nova Scotia Unlimited Liability Company (or any other company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law).

(*2*) With regard to India, a company deemed to be a public limited company solely by operation of section 43A(1) (relating to corporate ownership of the company), section 43A(1A) (relating to annual average turnover), or section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of section 3(1)(iii) of the Companies Act, 1956.

(*3*) With regard to Malaysia, a Sendirian Berhad.

(B) *Inclusions in certain cases.* With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(iii) *Public companies.* For purposes of paragraph (b)(8)(i) of this section, with regard to Cyprus, Hong Kong, and Jamaica, the term Public Limited Company includes any Limited Company that is not defined as a private company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(iv) *Limited companies.* For purposes of this paragraph (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

(v) *Multilingual countries.* Different linguistic renderings of the name of an entity listed in paragraph (b)(8)(i) of this section shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(b) (9) *Business entities with multiple charters.* (i) An entity created or organized under the laws of more than one jurisdiction if the rules of this section would treat it as a corporation with reference to any one of the jurisdictions in which it is created or organized. Such an entity may elect its classification under § 301.7701-3, subject to the limitations of those provisions, only if it is created or organized in each jurisdiction in a manner that meets the definition of an eligible entity in § 301.7701-3(a). The determination of a business entity's corporate or non-corporate classification is made independently from the determination of whether the entity is domestic or foreign. See § 301.7701-5 for the rules that determine whether a business entity is domestic or foreign.

(ii) *Examples.* The following examples illustrate the rule of this paragraph (b)(9):

Example 1.

(i) *Facts.* X is an entity with a single owner organized under the laws of Country A as an entity that is listed in paragraph (b)(8)(i) of this section. Under the rules of this section, such an entity is a corporation for Federal tax purposes and under § 301.7701-3(a) is unable to elect its classification. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State B, X is considered to be created or organized in State B as an LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this section and § 301.7701-3, an LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for Federal tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its Country A charter. Consequently, X is now organized in more than one jurisdiction.

(ii) *Result.* X remains organized under the laws of Country A as an entity that is listed in paragraph (b)(8)(i) of this section, and as such, it is an entity that is treated as a corporation under the rules of this section. Therefore, X is a corporation for Federal tax purposes because the rules of this section would treat X as a corporation with reference to one of the jurisdictions in which it is created or organized. Because X is organized in Country A in a manner that does not meet the definition of an eligible entity in § 301.7701-3(a), it is unable to elect its classification.

Example 2.

(i) *Facts.* Y is an entity that is incorporated under the laws of State A and has two shareholders. Under the rules of this section, an entity incorporated under the laws of State A is a corporation for Federal tax purposes and under § 301.7701-3(a) is unable to elect its classification. Several years after its formation, Y files a certificate of continuance in Country B as an unlimited company. Under the laws of Country B, upon filing a certificate of continuance, Y is treated as organized in Country B. Under the rules of this section and § 301.7701-3, an unlimited company organized only in Country B that has more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). Neither State A nor Country B law requires Y to terminate its charter in State

A as a result of the continuance, and in fact Y does not terminate its State A charter. Consequently, Y is now organized in more than one jurisdiction.

(ii) *Result.* Y remains organized in State A as a corporation, an entity that is treated as a corporation under the rules of this section. Therefore, Y is a corporation for Federal tax purposes because the rules of this section would treat Y as a corporation with reference to one of the jurisdictions in which it is created or organized. Because Y is organized in State A in a manner that does not meet the definition of an eligible entity in § 301.7701-3(a), it is unable to elect its classification.

Example 3.

(i) *Facts.* Z is an entity that has more than one owner and that is recognized under the laws of Country A as an unlimited company organized in Country A. Z is organized in Country A in a manner that meets the definition of an eligible entity in § 301.7701-3(a). Under the rules of this section and § 301.7701-3, an unlimited company organized only in Country A with more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). At the time Z was formed, it was also organized as a private limited company under the laws of Country B. Z is organized in Country B in a manner that meets the definition of an eligible entity in § 301.7701-3(a). Under the rules of this section and § 301.7701-3, a private limited company organized only in Country B is treated as a corporation for Federal tax purposes (absent an election to be treated as a partnership). Thus, Z is organized in more than one jurisdiction. Z has not made any entity classification elections under § 301.7701-3.

(ii) *Result.* Z is organized in Country B as a private limited company, an entity that is treated (absent an election to the contrary) as a corporation under the rules of this section. However, because Z is organized in each jurisdiction in a manner that meets the definition of an eligible entity in § 301.7701-3(a), it may elect its classification under § 301.7701-3, subject to the limitations of those provisions.

Example 4.

(i) *Facts.* P is an entity with more than one owner organized in Country A as a general partnership. Under the rules of this section and § 301.7701-3, an eligible entity with more than one owner in Country A is treated as a partnership for federal tax purposes (absent an election to be treated as an association). P files a certificate of continuance in Country B as an unlimited company. Under the rules of this section and § 301.7701-3, an unlimited company in Country B with more than one owner is treated as a partnership for federal tax purposes (absent an election to be treated as an association). P is not required under either the laws of Country A or Country B to terminate the general partnership in Country A, and in fact P does not terminate its Country A partnership. P is now organized in more than one jurisdiction. P has not made any entity classification elections under § 301.7701-3.

(ii) *Result.* P's organization in both Country A and Country B would result in P being classified as a partnership. Therefore, since the rules of this section would not treat P as a corporation with reference to any jurisdiction in which it is created or organized, it is not a corporation for federal tax purposes.

(c) *Other business entities.* For federal tax purposes -

(1) The term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) *Wholly owned entities* -

(i) *In general.* Except as otherwise provided in this paragraph (c), a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

(ii) *Special rule for certain business entities.* If the single owner of a business entity is a bank (as defined in section 581, or, in the case of a foreign bank, as defined in section 585(a)(2)(B) without regard to the second sentence thereof), then the special rules applicable to banks under the Internal Revenue Code will continue to apply to the single owner as if the wholly owned entity were a separate entity. For this purpose, the special rules applicable to banks under the Internal Revenue Code do not include the rules under sections 864(c), 882(c), and 884.

(iii) *Tax liabilities of certain disregarded entities* -

(A) *In general.* An entity that is disregarded as separate from its owner for any purpose under this section is treated as an entity separate from its owner for purposes of -

(*1*) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded;

(*2*) Federal tax liabilities of any other entity for which the entity is liable; and

(*3*) Refunds or credits of Federal tax.

(B) *Examples.* The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:

Example 1.

In 2006, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2005. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2009, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2005 taxable year. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

Example 2.

The facts are the same as in *Example 1,* except that in 2007, the IRS determines that X miscalculated and underreported its income tax liability for 2005. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

(iv) *Special rule for employment tax purposes* -

(A) *In general.* Except as provided in paragraph (c)(2)(iv)(C) of this section, paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply to taxes imposed under Subtitle C - Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(B) *Treatment of entity.* Except as provided in paragraph (c)(2)(iv)(C) of this section, an entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as a corporation with respect to taxes imposed under Subtitle C - Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code). For special rules regarding the application of certain employment tax exceptions, see §§ 31.3121(b)(3)-1(d), 31.3127-1(b), and 31.3306(c)(5)-1(d) of this chapter.

(C) *Special rules.*

(*1*) Paragraphs (c)(2)(iv)(A) and (B) of this section do not apply to withholding requirements imposed by section 3406 (backup withholding). Thus, in the case of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the owner is subject to the withholding requirements imposed by section 3406 (backup withholding).

(*2*) Paragraph (c)(2)(i) of this section applies to taxes imposed under subtitle A of the Code, including Chapter 2 - Tax on Self-Employment Income. Thus, an entity that is treated in the same manner as a sole proprietorship under paragraph (a) of this section is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity's activities. Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under this section is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under this section.

(D) *Example.* The following example illustrates the application of paragraph (c)(2)(iv) of this section:

Example.

(i) LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for Federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code. LLCA has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).

(ii) LLCA is subject to the provisions of subtitle C of the Internal Revenue Code and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, LLCA is required to perform such acts as are required of an employer under those provisions of the Internal Revenue Code and regulations thereunder that apply. All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts are applicable to LLCA. Thus, for example, LLCA is liable for income tax withholding, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. See sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, LLCA must file under its name and EIN the applicable Forms in the 94X series, for example, Form 941, “Employer's Quarterly Employment Tax Return,” Form 940, “Employer's Annual Federal Unemployment Tax Return;” file with the Social Security Administration and furnish to LLCA's employees statements on Forms W-2, “Wage and Tax Statement;” and make timely employment tax deposits. See §§ 31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1 of this chapter.

(iii) A is self-employed for purposes of subtitle A, chapter 2, Tax on Self-Employment Income, of the Internal Revenue Code. Thus, A is subject to tax under section 1401 on A's net earnings from self-employment with respect to LLCA's activities. A is not an employee of LLCA for purposes of subtitle C of the Internal Revenue Code. Because LLCA is treated as a sole proprietorship of A for income tax purposes, A is entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through LLCA, including the employer's share of employment taxes imposed under sections 3111 and 3301, on A's Form 1040, Schedule C, “Profit or Loss for Business (Sole Proprietorship).”

(v) *Special rule for certain excise tax purposes* -

(A) *In general.* Paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply for purposes of -

(*1*) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(*2*) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;

(*3*) Registration under sections 4101, 4222, 4412;

(*4*) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (c)(2)(v)(A)(*1*) of this section or under section 6426 or 6427; and

(*5*) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.

(B) *Treatment of entity.* An entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as a corporation with respect to items described in paragraph (c)(2)(v)(A) of this section.

(C) *Example.* The following example illustrates the provisions of this paragraph (c)(2)(v):

Example.

(i) LLCB is an eligible entity that has a single owner, B. LLCB is generally disregarded as an entity separate from its owner. However, under paragraph (c)(2)(v) of this section, LLCB is treated as an entity separate from its owner for certain purposes relating to excise taxes.

(ii) LLCB mines coal from a coal mine located in the United States. Section 4121 of chapter 32 of the Internal Revenue Code imposes a tax on the producer's sale of such coal. Section 48.4121-1(a) of this chapter defines a “producer” generally as the person in whom is vested ownership of the coal under state law immediately after the coal is severed from the ground. LLCB is the person that owns the coal under state law immediately after it is severed from the ground. Under paragraph (c)(2)(v)(A)(*1*) of this section, LLCB is the producer of the coal and is liable for tax on its sale of such coal under chapter 32 of the Internal Revenue Code. LLCB must report and pay tax on Form 720, “Quarterly Federal Excise Tax Return,” under its own name and taxpayer identification number.

(iii) LLCB uses undyed diesel fuel in an earthmover that is not registered or required to be registered for highway use. Such use is an off-highway business use of the fuel. Under section 6427(l), the ultimate purchaser is allowed to claim an income tax credit or payment related to the tax imposed on diesel fuel used in an off-highway business use. Under paragraph (c)(2)(v) of this section, for purposes of the credit or payment allowed under section 6427(l), LLCB is the person that could claim the amount on its Form 720 or on a Form 8849, “Claim for Refund of Excise Taxes.” Alternatively, if LLCB did not claim a payment during the time prescribed in section 6427(i)(2) for making a claim under section 6427, § 1.34-1 of this chapter provides that B, the owner of LLCB, could claim the income tax credit allowed under section 34 for the nontaxable use of diesel fuel by LLCB.

(iv) Assume the same facts as in paragraph (c)(2)(v)(C) *Example* (i) and (ii) of this section. If LLCB does not pay the tax on its sale of coal under chapter 32 of the Internal Revenue Code, any notice of lien the Internal Revenue Service files will be filed as if LLCB were a corporation.

(vi) *Special rule for reporting under section 6038A* -

(A) *In general.* An entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as an entity separate from its owner and classified as a corporation for purposes of section 6038A if -

(*1*) The entity is a domestic entity; and

(*2*) One foreign person has direct or indirect sole ownership of the entity.

(B) *Definitions* -

(*1*) *Indirect sole ownership.* For purposes of paragraph (c)(2)(vi)(A)(*2*) of this section, indirect sole ownership means ownership by one person entirely through one or more other entities disregarded as entities separate from their owners or through one or more grantor trusts, regardless of whether any such disregarded entity or grantor trust is domestic or foreign.

(*2*) *Entity disregarded as separate from its owner.* For purposes of paragraph (c)(2)(vi)(B)(*1*) of this section, an entity disregarded as an entity separate from its owner is an entity described in paragraph (c)(2)(i) of this section.

(*3*) *Grantor trust.* For purposes of paragraph (c)(2)(vi)(B)(*1*) of this section, a grantor trust is any portion of a trust that is treated as owned by the grantor or another person under subpart E of subchapter J of chapter 1 of the Code.

(C) *Taxable year.* The taxable year of an entity classified as a corporation for section 6038A purposes pursuant to paragraph (c)(2)(vi)(A) of this section is -

(*1*) The same as the taxable year of the foreign person described in paragraph (c)(2)(vi)(A)(*2*) of this section, if that foreign person has a U.S. income tax or information return filing obligation for its taxable year; or

(*2*) The calendar year, if paragraph (c)(2)(vi)(C)(*1*) of this section does not apply, unless otherwise provided in forms, instructions, or published guidance.

(d) *Special rule for certain foreign business entities* -

(1) *In general.* Except as provided in paragraph (d)(3) of this section, a foreign business entity described in paragraph (b)(8)(i) of this section will not be treated as a corporation under paragraph (b)(8)(i) of this section if -

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant (as defined in § 301.7701-3(d)) on May 8, 1996;

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) *Binding contract rule.* If a foreign business entity described in paragraph (b)(8)(i) of this section is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage

(directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, paragraph (d)(1) of this section will be applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) *Termination of grandfather status* -

(i) *In general.* An entity that is not treated as a corporation under paragraph (b)(8)(i) of this section by reason of paragraph (d)(1) or (d)(2) of this section will be treated permanently as a corporation under paragraph (b)(8)(i) of this section from the earliest of:

(A) The effective date of an election to be treated as an association under § 301.7701-3;

(B) A termination of the partnership under section 708(b)(1)(B) (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period);

(C) A division of the partnership under section 708(b)(2)(B); or

(D) The date any person or persons, who were not owners of the entity as of November 29, 1999, own in the aggregate a 50 percent or greater interest in the entity.

(ii) *Special rule for certain entities.* For purposes of paragraph (d)(2) of this section, paragraph (d)(3)(i)(B) of this section shall not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity.

(e) *Effective/applicability date.*

(1) Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997, except that paragraph (b)(6) of this section applies on or after January 14, 2002, to a business entity wholly owned by a foreign government regardless of any prior entity classification, and paragraph (c)(2)(ii) of this section applies to taxable years beginning after January 12, 2001. The reference to the Finnish, Maltese, and Norwegian entities in paragraph (b)(8)(i) of this section is applicable on November 29, 1999. The reference to the Trinidadian entity in paragraph (b)(8)(i) of this section applies to entities formed on or after November 29, 1999. Any Maltese or Norwegian entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any Finnish entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997. However, paragraph (d)(3)(i)(D) of this section applies on or after October 22, 2003.

(2) Paragraph (c)(2)(iii) of this section applies on and after September 14, 2009. For rules that apply before September 14, 2009, see 26 CFR part 301, revised as of April 1, 2009.

(3)

(i) *General rule.* Except as provided in paragraph (e)(3)(ii) of this section, the rules of paragraph (b)(9) of this section apply as of August 12, 2004, to all business entities existing on or after that date.

(ii) *Transition rule.* For business entities created or organized under the laws of more than one jurisdiction as of August 12, 2004, the rules of paragraph (b)(9) of this section apply as of May 1, 2006. These entities, however, may rely on the rules of paragraph (b)(9) of this section as of August 12, 2004.

(4) The reference to the Estonian, Latvian, Liechtenstein, Lithuanian, and Slovenian entities in paragraph (b)(8)(i) of this section applies to such entities formed on or after October 7, 2004, and to any

such entity formed before such date from the date any person or persons, who were not owners of the entity as of October 7, 2004, own in the aggregate a 50 percent or greater interest in the entity. The reference to the European Economic Area/European Union entity in paragraph (b)(8)(i) of this section applies to such entities formed on or after October 8, 2004.

(5)

(i) Except as provided in this paragraph (e)(5), paragraph (c)(2)(iv) of this section applies with respect to wages paid on or after January 1, 2009.

(ii) Paragraph (c)(2)(iv)(B) applies with respect to wages paid on or after September 14, 2009. For rules that apply before September 14, 2009, see 26 CFR part 301 revised as of April 1, 2009.

(iii) Paragraph (c)(2)(iv)(C)(*1*) of this section applies with respect to wages paid on or after November 1, 2011. For rules that apply before November 1, 2011, see 26 CFR part 301, revised as of April 1, 2011. However, taxpayers may apply paragraph (c)(2)(iv)(C)(*1*) of this section with respect to wages paid on or after January 1, 2009.

(6)

(i) Except as provided in this paragraph (e)(6), paragraph (c)(2)(v) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

(ii) Paragraphs (c)(2)(v)(B) and (c)(2)(v)(C) *Example* (iv) of this section apply on and after September 14, 2009.

(iii) Paragraph (c)(2)(v)(A)(*5*) of this section applies for periods after December 31, 2014.

(iv) References to Chapter 49 in paragraph (c)(2)(v) of this section apply to taxes imposed on amounts paid on or after July 1, 2012.

(7) The reference to the Bulgarian entity in paragraph (b)(8)(i) of this section applies to such entities formed on or after January 1, 2007, and to any such entity formed before such date from the date that, in the aggregate, a 50 percent or more interest in such entity is owned by any person or persons who were not owners of the entity as of January 1, 2007. For purposes of the preceding sentence, the term *interest* means -

(i) In the case of a partnership, a capital or profits interest; and

(ii) In the case of a corporation, an equity interest measured by vote or value.

(8) Paragraph (c)(2)(iv)(C)(*2*) of this section applies on the later of -

(i) August 1, 2016; or

(ii) The first day of the latest-starting plan year beginning after May 4, 2016, and on or before May 4, 2017, of an affected plan (based on the plans adopted before, and the plan years in effect as of, May 4, 2016) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under this section. For rules that apply before the applicability date of paragraph (c)(2)(iv)(C)(*2*) of this section, see 26 CFR part 301 revised as of April 1, 2016. For the purposes of this paragraph (e)(8) -

(A) An affected plan includes any qualified plan, health plan, or section 125 cafeteria plan if the plan benefits participants whose employment status is affected by paragraph (c)(2)(iv)(C)(*2*) of this section;

(B) A qualified plan means a plan, contract, pension, or trust described in paragraph (A) or (B) of section 219(g)(5) (other than paragraph (A)(iii)); and

(C) A health plan means an arrangement described under § 1.105-5 of this chapter.

(9) *Reporting required under section 6038A.* Paragraph (c)(2)(vi) of this section applies to taxable years of entities beginning after December 31, 2016, and ending on or after December 13, 2017.

[T.D. 8697, 61 FR 66589, Dec. 18, 1996, as amended by T.D. 8844, 64 FR 66583, Nov. 29, 1999; T.D. 9012, 67 FR 49864, Aug. 1, 2002; T.D. 9093, 68 FR 60298, Oct. 22, 2003; T.D. 9153, 69 FR 49810, Aug. 12, 2004; T.D. 9183, 70 FR 9221, Feb. 25, 2005; T.D. 9197, 70 FR 19698, Apr. 14, 2005; T.D. 9235, 70 FR 74658, Dec. 16, 2005; T.D. 9246, 71 FR 4817, Jan. 30, 2006; T.D. 9356, 72 FR 45893, Aug. 16, 2007; T.D. 9388, 73 FR 15065, Mar. 21, 2008; T.D. 8697, 73 FR 18442, Apr. 4, 2008; 73 FR 21415, Apr. 21, 2008; T.D. 9433, 73 FR 72346, Nov. 28, 2008; T.D. 9462, 74 FR 46904, Sept. 14, 2009; T.D. 9553, 76 FR 66182, Oct. 26, 2011; T.D. 9554, 76 FR 67365, Nov. 1, 2011; T.D. 9596, 77 FR 37807, June 25, 2012; T.D. 9655, 79 FR 8601, Feb. 12, 2014; T.D. 9670, 79 FR 36206, June 26, 2014; T.D. 9766, 81 FR 26694, May 4, 2016; T.D. 9796, 81 FR 89851, Dec. 13, 2016; T.D. 9869, 84 FR 31479, July 2, 2019]

§ 301.7701-3 Classification of certain business entities.

(a) *In general.* A business entity that is not classified as a corporation under § 301.7701-2(b) (1), (3), (4), (5), (6), (7), or (8) (an *eligible entity*) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections, including a rule under which a domestic eligible entity that elects to be classified as an association consents to be subject to the dual consolidated loss rules of section 1503(d). Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) *Classification of eligible entities that do not file an election* -

(1) *Domestic eligible entities.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is -

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) *Foreign eligible entities* -

(i) *In general.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is -

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) *Definition of limited liability.* For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

(3) *Existing eligible entities* -

(i) *In general.* Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under §§ 301.7701-1 through 301.7701-3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities prior to the effective date of this section, see paragraph (h)(2) of this section.

(ii) *Special rules.* For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

(c) *Elections* -

(1) *Time and place for filing* -

(i) *In general.* Except as provided in paragraphs (c)(1) (iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See § 301.6109-1 for rules on applying for and displaying Employer Identification Numbers.

(ii) *Further notification of elections.* An eligible entity required to file a Federal tax or information return for the taxable year for which an election is made under § 301.7701-3(c)(1)(i) must attach a copy of its Form 8832 to its Federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 ("Entity Classification Election") must be attached to the Federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under § 301.7701-3(c)(1)(i) will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the Federal tax or information returns are inconsistent with the entity's election under § 301.7701-3(c)(1)(i). In the case of returns for taxable years beginning after December 31, 2002, the copy of Form 8832 attached to a return pursuant to this paragraph (c)(1)(ii) is not required to be a signed copy.

(iii) *Effective date of election.* An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

(iv) *Limitation.* If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election. An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

(v) *Deemed elections* -

(A) *Exempt organizations.* An eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

(B) *Real estate investment trusts.* An eligible entity that files an election under section 856(c)(1) to be treated as a real estate investment trust is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day the entity is treated as a real estate investment trust.

(C) *S corporations.* An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under § 301.7701-3(c)(1)(i), to be classified as other than an association.

(vi) *Examples.* The following examples illustrate the rules of this paragraph (c)(1):

Example 1.

On July 1, 1998, X, a domestic corporation, purchases a 10% interest in Y, an eligible entity formed under Country A law in 1990. The entity's classification was not relevant to any person for federal tax or information purposes prior to X's acquisition of an interest in Y. Thus, Y is not considered to be in existence on the effective date of this section for purposes of paragraph (b)(3) of this section. Under the applicable Country A statute, all members of Y have limited liability as defined in paragraph (b)(2)(ii) of this section. Accordingly, Y is classified as an association under paragraph (b)(2)(i)(B) of this section unless it elects under this paragraph (c) to be classified as a partnership. To be classified as a partnership as of July 1, 1998, Y must file a Form 8832 by September 14, 1998. See paragraph (c)(1)(i) of this section. Because an election cannot be effective more than 75 days prior to the date on which it is filed, if Y files its Form 8832 after September 14, 1998, it will be classified as an association from July 1, 1998, until the effective date of the election. In that case, it could not change its classification by election under this paragraph (c) during the sixty months succeeding the effective date of the election.

Example 2.

(i) Z is an eligible entity formed under Country B law and is in existence on the effective date of this section within the meaning of paragraph (b)(3) of this section. Prior to the effective date of this section, Z claimed to be classified as an association. Unless Z files an election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) *Authorized signatures* -

(i) *In general.* An election made under paragraph (c)(1)(i) of this section must be signed by -

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) *Retroactive elections.* For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(iii) *Changes in classification.* For paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after November 29, 1999.

(3) *Consent to be subject to section 1503(d)* -

(i) *Rule.* A domestic eligible entity that elects to be classified as an association consents to be treated as a dual resident corporation for purposes of section 1503(d) (such an entity, a *domestic consenting corporation*), for any taxable year for which it is classified as an association and the condition set forth in § 1.1503(d)-1(c)(1) of this chapter is satisfied.

(ii) *Transition rule - deemed consent.* If, as a result of the applicability date (see paragraph (c)(3)(iii) of this section) relating to paragraph (c)(3)(i) of this section, a domestic eligible entity that is classified as an association has not consented to be treated as a domestic consenting corporation pursuant to paragraph (c)(3)(i) of this section, then the domestic eligible entity is deemed to consent to be so treated as of its first taxable year beginning on or after December 20, 2019. The first sentence of this paragraph (c)(3)(ii) does not apply if the domestic eligible entity elects, on or after December 20, 2018 and effective before its first taxable year beginning on or after December 20, 2019, to be classified as a partnership or disregarded entity such that it ceases to be a domestic eligible entity that is classified as an association. For purposes of the election described in the second sentence of this paragraph (c)(3)(ii), the sixty month limitation under paragraph (c)(1)(iv) of this section is waived.

(iii) *Applicability date.* The sixth sentence of paragraph (a) of this section and paragraph (c)(3)(i) of this section apply to a domestic eligible entity that on or after December 20, 2018 files an election to be classified as an association (regardless of whether the election is effective before December 20, 2018). Paragraph (c)(3)(ii) of this section applies as of December 20, 2018.

(f) *Changes in number of members of an entity* -

(1) *Associations.* The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.

(2) *Partnerships and single member entities.* An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member. If an elective classification change under paragraph (c) of this section is effective at the same time as a membership change described in this paragraph (f)(2), the deemed transactions in paragraph (g) of this section resulting from the elective change preempt the transactions that would result from the change in membership.

(3) *Effect on sixty month limitation.* A change in the number of members of an entity does not result in the creation of a new entity for purposes of the sixty month limitation on elections under paragraph (c)(1)(iv) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (f):

Example 1. A,

a U.S. person, owns a domestic eligible entity that is disregarded as an entity separate from its owner. On January 1, 1998, *B,* a U.S. person, buys a 50 percent interest in the entity from *A.* Under this paragraph (f), the entity is classified as a partnership when *B* acquires an interest in the entity. However, *A* and *B* elect to have the entity classified as an association effective on January 1, 1998. Thus, *B* is treated as buying shares of stock on January 1, 1998. (Under paragraph (c)(1)(iv) of this section, this election is treated as a change in classification so that the entity generally cannot change its classification by election again during the sixty months succeeding the effective date of the election.) Under paragraph (g)(1) of this section, *A* is treated as contributing the assets and liabilities of the entity to the newly formed association immediately before the close of December 31, 1997. Because *A* does not retain control of the association as required by section 351, *A*'s contribution will be a taxable event. Therefore, under section 1012, the association will take a fair market value basis in the assets contributed by *A,* and *A* will have a fair market value basis in the stock received. *A* will have no additional gain upon the sale of stock to *B,* and *B* will have a cost basis in the stock purchased from *A.*

Example 2.

(i) On April 1, 1998, *A* and *B,* U.S. persons, form *X,* a foreign eligible entity. *X* is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and *X* does not make an election to be classified as a partnership. *A* subsequently purchases all of *B*'s interest in *X.*

(ii) Under paragraph (f)(1) of this section, *X* continues to be classified as an association. *X,* however, can subsequently elect to be disregarded as an entity separate from *A.* The sixty month limitation of paragraph (c)(1)(iv) of this section does not prevent *X* from making an election because *X* has not made a prior election under paragraph (c)(1)(i) of this section.

Example 3.

(i) On April 1, 1998, *A* and *B,* U.S. persons, form *X,* a foreign eligible entity. *X* is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and *X* does not make an election to be classified as a partnership. On January 1, 1999, *X* elects to be classified as a partnership effective on that date. Under the sixty month limitation of paragraph (c)(1)(iv) of this section, *X* cannot elect to be classified as an association until January 1, 2004 (*i.e.*, sixty months after the effective date of the election to be classified as a partnership).

(ii) On June 1, 2000, *A* purchases all of *B*'s interest in *X.* After *A*'s purchase of *B*'s interest, *X* can no longer be classified as a partnership because *X* has only one member. Under paragraph (f)(2) of this section, *X* is disregarded as an entity separate from *A* when *A* becomes the only member of *X. X,* however, is not treated as a new entity for purposes of paragraph (c)(1)(iv) of this section. As a result, the sixty month limitation of paragraph (c)(1)(iv) of this section continues to apply to *X,* and *X* cannot elect to be classified as an association until January 1, 2004 (*i.e.*, sixty months after January 1, 1999, the effective date of the election by *X* to be classified as a partnership).

(5) *Effective date.* This paragraph (f) applies as of November 29, 1999.

(g) *Elective changes in classification* -

(1) *Deemed treatment of elective change* -

(i) *Partnership to association.* If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(ii) *Association to partnership.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(iii) *Association to disregarded entity.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(iv) *Disregarded entity to an association.* If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) *Effect of elective changes* -

(i) *In general.* The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(ii) *Adoption of plan of liquidation.* For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the election to be classified as a partnership or to be disregarded as an entity separate from its owner is adopted on an earlier date, the making, by an association, of an election under paragraph (c)(1)(i) of this section to be classified as a partnership or to be disregarded as an entity separate from its owner is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (g)(1)(ii) or (iii) of this section. This paragraph (g)(2)(ii) applies to elections filed on or after December 17, 2001. Taxpayers may apply this paragraph (g)(2)(ii) retroactively to elections filed before December 17, 2001, if the corporate owner claiming treatment under section 332 and its subsidiary making the election take consistent positions with respect to the federal tax consequences of the election.

(3) *Timing of election* -

(i) *In general.* An election under paragraph (c)(1)(i) of this section that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this paragraph (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in paragraph (g)(1)(ii) of this section (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

(ii) *Coordination with section 338 election.* A purchasing corporation that makes a qualified stock purchase of an eligible entity taxed as a corporation may make an election under section 338 regarding the acquisition if it satisfies the requirements for the election, and may also make an election to change the classification of the target corporation. If a taxpayer makes an election under section 338 regarding its acquisition of another entity taxable as a corporation and makes an election under paragraph (c) of this section for the acquired corporation (effective at the earliest possible date as provided by paragraph (c)(1)(iii) of this section), the transactions under paragraph (g) of this section are deemed to occur immediately after the deemed asset purchase by the new target corporation under section 338.

(iii) *Application to successive elections in tiered situations.* When elections under paragraph (c)(1)(i) of this section for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the elections on Form 8832. If no order is specified for the elections, any transactions that are deemed to occur in this paragraph (g) as a result of the classification change will be treated as occurring first for the highest tier entity's classification change, then for the next highest tier entity's classification change, and so forth down the chain of entities until all the transactions under this paragraph (g) have occurred. For example, Parent, a corporation, wholly owns all of the interest of an eligible entity classified as an association (S1), which wholly owns another eligible entity classified as an association (S2), which wholly owns another eligible entity classified as an association (S3). Elections under paragraph (c)(1)(i) of this section are filed to classify S1, S2, and S3 each as disregarded as an entity separate from its owner effective on the same day. If no order is specified for the elections, the following transactions are deemed to occur under this paragraph (g) as a result of the elections, with each successive transaction occurring on the same day immediately after the preceding transaction S1 is treated as liquidating into Parent, then S2 is treated as liquidating into Parent, and finally S3 is treated as liquidating into Parent.

(4) *Effective date.* Except as otherwise provided in paragraph (g)(2)(ii) of this section, this paragraph (g) applies to elections that are filed on or after November 29, 1999. Taxpayers may apply this paragraph

(g) retroactively to elections filed before November 29, 1999 if all taxpayers affected by the deemed transactions file consistently with this paragraph (g).