

Partial Withdrawal of, and Amendment to, Notice of Proposed Rulemaking; Notice of Proposed Rulemaking and Notice of Public Hearing

Adjustments Following Sales of Partnership Interests

REG-209682-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking, amendment to notice of proposed rulemaking; notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document withdraws a portion of the notice of proposed rulemaking published in the **Federal Register**, February 16, 1984 (49 F.R. 5940); contains proposed regulations relating to the optional adjustments to the basis of partnership property following certain transfers of partnership interests under section 743, the calculation of gain or loss under section 751(a) following the sale or exchange of a partnership interest, the allocation of basis adjustments among partnership assets under section 755, and the allocation of a partner's basis in its partnership interest to properties distributed to the partner by the partnership under section 732(c); and, finally, amends proposed regulations relating to the computation of a partner's proportionate share of the adjusted basis of depreciable property (or depreciable real property) under section 1017. The changes are necessary to provide clearer guidance on the proper application of these sections and will effect partnerships and partners where there are transfers of partnership interests, distributions of property, or elections under sections 108(b)(5) or (c). In addition, the proposed regulations under section 732(c) reflect changes to the law made by the Taxpayer Relief Act of 1997.

DATES: Written comments must be received by April 29, 1998. Outlines of topics to be discussed at the public hearing scheduled for Wednesday, July 8, 1998, at

10 a.m. must be received by Wednesday, June 24, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209682-94), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-209682-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at [http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html).

The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Terri A. Belanger, (202) 622-3070; concerning submissions and the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

*Paperwork Reduction Act*

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by March 30, 1998. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal**

**Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up cost and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in §§1.743-1(b), 1.743-1(k), and 1.755-1. This information is required in order for partners to have adequate knowledge to comply with section 743 and for the IRS to verify compliance with section 743. This information will be used to determine whether the amount of tax has been computed correctly. Responses to this collection of information are mandatory for partnerships that have made an election under section 754 and for which a section 743 transfer has been made. The likely respondents are businesses or other for-profit institutions.

Estimated total annual recordkeeping burden under §1.743-1(b): 600,000 hours

The estimated annual burden per recordkeeper varies from **1 hour** to **300 hours**, depending on the individual circumstances, with an estimated average of **4 hours**.

Estimated number of recordkeepers: 150,000

Estimated total annual reporting burden under §1.743-1(k)(1): 225,000 hours

The estimated annual burden per respondent is estimated at an average of **3 hours**.

Estimated number of respondents: 75,000

Estimated frequency of responses: On occasion.

Estimated total annual reporting burden under §1.743-1(k)(2): 75,000 hours

The estimated annual burden per respondent is estimated at an average of **1 hour**.

Estimated number of respondents: 75,000

Estimated frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### *Background*

This document proposes to (a) revise §§1.743-1 and 1.755-1 of the Income Tax Regulations (26 CFR part 1), (b) withdraw §1.168-2(n) of the proposed Income Tax Regulations published on February 16, 1984 (49 F.R. 5940), and (c) amend §§1.732-1, 1.732-2, 1.734-1, 1.751-1 of the Income Tax Regulations, and §1.1017-1 of the proposed Income Tax Regulations published January 7, 1997 (62 F.R. 955).

Section 743(b) provides for an optional adjustment to the basis of partnership property following certain transfers of partnership interests. The Code provides for basis adjustments in an attempt to coordinate the transferee's tax consequences and economic consequences. The amount of the basis adjustment is the difference between the transferee's basis in the partnership interest (outside basis) and its share of the partnership's basis in the partnership's assets (inside basis). Once the amount of the basis adjustment is determined, it is allocated among the partnership's various assets pursuant to section 755.

The proposed regulations coordinate sections 704(c), 743, 751, and 755, and reflect changes in the Code and Income Tax Regulations since the adoption of the current regulations. The proposed regulations also provide rules concerning adjustments to the basis of partnership property made pursuant to section 1017(b)(3)(C). The proposed regulations describe how to determine a partner's proportionate share of the adjusted basis of depreciable property (or depreciable real property) under section 1017, and clarify that an adjustment to the basis of

partnership property made under section 1017(b)(3)(C) is treated in the same manner as an adjustment to the basis of partnership property made under section 743.

Section 732(c) provides for the allocation of a partner's basis in its partnership interest upon certain distributions of property to the partner by the partnership. Section 732(c) was amended by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1061, 111 Stat. 788, 945-46 (1997). Under prior law, the allocation was made based on the adjusted basis of the distributed property to the partnership immediately before the distribution. Under the new law, the allocation is made, in general, based on the fair market value of the distributed property on the date of distribution. The proposed regulations amend the existing regulations under section 732 to reflect this change.

### *Explanation of Provisions*

#### *A. Section 743*

##### *In General*

If an election is in effect under section 754, section 743 requires the partnership to adjust the basis of partnership property upon the transfer of an interest in the partnership by sale or exchange or on the death of a partner. The partnership is required to increase the adjusted basis of partnership property by the excess of the transferee's basis in the transferred partnership interest over the transferee's share of the adjusted basis to the partnership of the partnership's property. The partnership is also required to decrease the adjusted basis of partnership property by the excess of the transferee's share of the adjusted basis to the partnership of partnership property over the transferee's basis in the transferred partnership interest.

The proposed regulations address a number of issues raised in connection with the calculation, treatment, and reporting of basis adjustments under section 743. In particular, the proposed regulations (i) clarify the manner in which the partnership calculates a transferee's income, gain, loss, or deduction when the transferee has a basis adjustment under section 743 (including the recovery of negative basis adjustments) and (ii) coordinate sections 743 and 704(c) when partnerships elect the remedial allocation method under §1.704-3(d). The proposed

regulations also provide that partnerships (rather than partners) are required to make and report the basis adjustments under section 743(b). Partnerships are required to adjust the transferee's distributive share of partnership tax items so that the information reported on the transferee's Schedule K-1 reflects the adjustments to the transferee's distributive share of the partnership items affected by the basis adjustment.

### *Determining the Amount of the Basis Adjustment*

The amount of the basis adjustment with respect to partnership property under section 743 is the difference between the transferee's share of the partnership's inside basis and the transferee's outside basis. The current regulations provide that a partner's share of the adjusted basis of partnership property is equal to the sum of the partner's interest as a partner in partnership capital and surplus, plus the partner's share of partnership liabilities. The current regulations also provide that where section 704(c) applies to property contributed to the partnership, section 704(c) is taken into account in determining a partner's share of the adjusted basis of partnership property.

The current regulations do not provide, other than by example, specific guidance on how to determine a transferee partner's share of the adjusted basis of partnership property. The proposed regulations provide that 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. The partner's share of the partnership's previously taxed capital is determined by reference to a hypothetical transaction in which (immediately after the transfer of the partnership interest) the partnership is assumed to have sold all of its assets in a fully taxable transaction for cash equal to the fair market value of the assets. The partner's share of the partnership's previously taxed capital is equal to (i) the amount of cash that the transferee would receive on liquidation of the partnership immediately following the hypothetical transaction, increased by (ii) the amount of tax loss that would be allocated

to the transferee from the hypothetical transaction, and decreased by (iii) the amount of tax gain that would be allocated to the transferee from the hypothetical transaction.

#### *Calculation of Income, Gain, or Loss*

The basis adjustment under section 743, like any other basis amount, is a reference used to calculate income, gain, loss, and deduction. However, generally the basis adjustment under section 743 is an adjustment with respect to the transferee. No adjustment is made to the common basis of partnership property (i.e., the partnership's adjusted basis for the property). Thus, for purposes of income, deduction, gain, loss, and distribution, the transferee will have a special basis for those partnership properties that are adjusted under section 743(b). The proposed regulations clarify the rules contained in the current regulations.

The basis adjustment under section 743 does not affect the partnership's computation of any item under section 703, and does not have any effect on the partners' capital accounts. Partnerships compute their tax items at the partnership level under section 703 without regard to the basis adjustments. Partnership level tax items (including any remedial allocations under §1.704-3(d)) are then allocated among the partners, including the transferee, in accordance with section 704. Finally, the partnership adjusts the transferee's distributive share of partnership tax items to reflect the transferee's special basis in the properties that give rise to the tax items. A transferee's income, gain, or loss from the sale of partnership property in which the transferee has a basis adjustment is equal to the transferee's distributive share of partnership income, gain, or loss (including any remedial allocations under §1.704-3(d)) from the sale of the property adjusted to account for the amount of the transferee's basis adjustment with respect to the property.

#### *Coordination of Section 743 with Section 704(c)*

Section 704(c) is taken into account in determining a transferee's share of the partnership's basis in the partnership's assets. As a result, some or all of a transferee's basis adjustment may be attributable to section 704(c) built-in gain or loss

when a transferee purchases a partnership interest from a partner that contributed section 704(c) property to the partnership. For example, assume that A contributes property with a fair market value of \$100 and an adjusted tax basis of \$10 to a partnership for a fifty percent interest and B contributes \$100 of cash for the remaining fifty percent interest. Immediately after the formation of the partnership, A's share of the partnership's basis in the partnership property is \$10, while B's share is \$100. The contributed asset then appreciates in value to \$120, and A transfers its entire interest to T for \$110 while an election is in effect under section 754. T will have a basis adjustment of \$100. The first \$90 of the basis adjustment is attributable to the section 704(c) built-in gain, while the remaining \$10 of the basis adjustment is attributable to T's fifty percent share of the \$20 of post-contribution appreciation in the contributed property.

Despite the fact that a portion of the basis adjustment may be attributable to a property's section 704(c) built-in gain, section 704(c) and section 743 operate independently. Section 1.704-1(b)(2)(iv)-(g)(3) requires a partnership to recover the value of section 704(c) property on the books of the partnership over the property's remaining useful life, determined with reference to the property's useful life in the hands of the contributing partner. At the same time, §1.168-2(n)(1) of the proposed Income Tax Regulations provides that the entire basis adjustment is recovered as though it is new property. Cf. Sections 168(i)(7) and 197(f)(2). As a result, the book and tax items representing the section 704(c) built-in gain are recovered over different periods.

Although a portion of the basis adjustment may represent actual tax basis equal to the amount of the section 704(c) built-in gain, the deductions attributable to the basis adjustment cannot be allocated to the noncontributing partner. The basis adjustment does not, therefore, eliminate any book-tax disparities that result from ceiling rule problems relating to the section 704(c) property. Because the basis adjustment only affects the transferee, the Service and Treasury believe that it is appropriate for sections 704(c) and 743(b) to operate independently.

When a partnership adopts the remedial allocation method, however, the partners

may be viewed as agreeing to shift, over time, a portion of the partnership's basis in its assets from the noncontributing partner to the contributing partner. Partnership basis that was considered part of the noncontributing partner's share of the partnership's basis at the time the adjustment to basis was made will be transferred to the contributing partner as the property is recovered on the partnership's books. In addition, a partnership that adopts the remedial allocation method with respect to contributed property must depreciate or amortize the portion of the contributed property's book basis that is attributable to section 704(c) built-in gain as though it is new property at the time of contribution. As a result, the Service and Treasury believe that it is appropriate to coordinate the recovery periods of the section 704(c) built-in gain and the built-in gain portion of the basis adjustment where the partnership uses the remedial allocation method.

Where a partnership adopts the remedial allocation method, the proposed regulations treat the portion of any basis adjustment that is attributable to section 704(c) built-in gain differently from the rest of the basis adjustment. Instead of treating the section 704(c) built-in gain portion of the basis adjustment and the basis adjustment in excess of such amount as newly acquired property, the section 704(c) built-in gain portion of the basis adjustment is recovered over the remaining cost recovery period for the section 704(c) built-in gain. The recovery period for the partner's share of common basis continues to be determined by reference to the property's useful life in the hands of the contributing partner, and the remaining basis adjustment in excess of the section 704(c) built-in gain portion of the basis adjustment is recovered as if it were new property.

If a partnership receives remedial allocations of income under §1.704-3(d) with respect to an item of adjusted partnership property, the partner does not offset the cost recovery deductions from the property against the remedial allocations of income. Rather, the partner will receive an allocation of remedial income and a separate cost recovery deduction. If a partner receives remedial allocations of deductions under §1.704-3(d) with respect to an item of partnership property that has a

negative basis adjustment, the partner first adds the amount of the remedial allocation of deduction to any common basis deductions received from the property. The partner then reduces the total amount of deductions from the property by the amount of the negative basis adjustment recovered in that year.

One result of this proposal is that the interests in a partnership will generally be fungible (i.e. the tax consequences that stem from the purchase of a partnership interest do not vary with the identity of the transferor), if (i) each partnership interest has an identical right in capital and profits, and (ii) each item of the partnership's section 704(c) property is subject to the remedial allocation method. The Service and Treasury request comments on situations in which the fungibility of partnership interests may otherwise be accommodated without significantly adding to the complexity of subchapter K. In addition, comments are requested concerning the application of the remedial allocation method to contributed property where there are no distortions caused by the ceiling rule at the time the property is contributed to the partnership.

#### *Recovery of Negative Basis Adjustments*

Section 1.168-2(n)(2) of the proposed Income Tax Regulations provides that a negative basis adjustment to depreciable property is recovered over the property's remaining recovery period in the hands of the partnership (i.e., the adjustment made to the common basis of the partnership property). The portion of the adjustment that is recovered in any year is equal to the product of (i) the amount of the decrease to the item's adjusted basis (determined as of the date of the transfer), multiplied by (ii) 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 transfer (determined prior to any basis adjustments).

Because the basis adjustment under section 743 is personal to the transferee, the primary method adopted by the proposed regulations for recovering a negative basis adjustment provides that the basis adjustment does not affect the common basis of partnership property and does not affect the tax consequences of

partners other than the transferee. Under this method, the recovery of the negative basis adjustment may generate ordinary income to the extent that it exceeds the transferee's share of the depreciation deductions. The proposed regulations provide that, unless the partnership elects to make a common basis adjustment, as described below, the amount of the basis adjustment recovered in any year first decreases the transferee's distributive share of the partnership's deductions from the adjusted item of property for that year. If, in any year, a partnership does not allocate to a transferee sufficient deductions from the adjusted property to offset the recovery of the negative basis adjustment, then the transferee's distributive share of the deductions from other items of partnership property is decreased. The transferee then recognizes income equal to the excess of the amount of the negative basis adjustment recovered in the year over the transferee's share of deductions from the other items of property for the year.

As an alternative, the proposed regulations also allow partnerships to elect to follow the approach of the old proposed regulations. If this election is made, the partnership treats the amount of the negative basis adjustment as an item of built-in gain, decreasing the total amount of depreciation or amortization that the partnership may allocate for tax purposes. This election would prevent the transferee from ever recognizing income in situations where the partnership did not allocate to the transferee sufficient depreciation to offset the negative basis adjustment. It should be noted, however, that this election has no effect on the partners' capital accounts, which continue to be adjusted to reflect the depreciation or amortization of the adjusted property as though there was no basis adjustment to the property. Consequently, to the extent that the basis adjustment causes the amount of the deductions allocated to the non-transferee partners for book purposes to exceed the amount of tax depreciation available to be allocated to them by the partnership, a book-tax disparity results for the non-transferee partners.

The Service and Treasury request comments concerning the recovery of negative basis adjustments under section 743. Specifically, the Service and Treasury request comments regarding whether there

are other possible ways of accounting for the recovery of negative basis adjustments that treat the basis adjustment as personal to the transferee and, at the same time, do not interfere with the economic agreement among the partners.

#### *Reporting and Returns*

The statutory language of section 743(b) indicates that partnerships are responsible for making the basis adjustments. This mandate is repeated in the language of the current regulations issued under both sections 743 and 755. Notwithstanding that partnerships are required to make and allocate basis adjustments under the current regulations, transferees are required to report the basis adjustments. Transferees accomplish this by attaching statements to their returns that show how the section 743(b) adjustment was determined and how the adjustment was allocated among the various partnership properties. No existing guidance indicates when (i.e., before or after the Schedule K-1) the effect of the basis adjustment to specific partnership items is to be determined or who is required to make and report the adjustments to the partnership items.

The proposed regulations clarify that partnerships are required to make the basis adjustments. In addition, the proposed regulations place the responsibility for reporting basis adjustments on partnerships. Partnerships report basis adjustments by attaching statements to their partnership returns when they acquire knowledge of transfers subject to section 743. In addition, partnerships are required to adjust specific partnership items in light of the basis adjustments. Consequently, amounts reported on the transferee's Schedule K-1 are adjusted amounts.

Transferees are subject to an affirmative obligation to notify partnerships of their basis in acquired partnership interests. To accommodate partnership concerns about the reliability of the information provided, partnerships are entitled to rely on the written representations of transferees concerning either the amount paid for the partnership interest or the transferee's basis in the partnership interest under section 1014 (unless clearly erroneous).

## B. Section 751

Section 751(a) provides that to the extent an amount realized on the sale or exchange of a partnership interest is attributable to the transferor's interest in unrealized receivables or inventory items of the partnership, the amount realized is considered to be an amount realized from the sale or exchange of property other than a capital asset. Thus, the transferor partner may recognize ordinary income or loss on the sale or exchange of its partnership interest. Under the current section 751 regulations, the amount of income or loss realized by a partner on the sale or exchange of an interest in section 751 property is equal to the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the transferor partner's basis in its partnership interest allocated to the property. Generally, the portion of the total amount realized allocated to section 751 property is determined by the seller and purchaser in an arm's length agreement. The portion of the partner's adjusted basis in the partnership interest allocated to the section 751 property equals the basis that the property would have had under section 732 if the transferor partner had received its proportionate share of the property in a current distribution immediately before the sale.

The proposed regulations amend these rules for determining the transferor partner's gain or loss from the sale or exchange of its interest in section 751 property. Rather than attempting to allocate a portion of the transferor partner's amount realized and adjusted basis to the section 751 property, the proposed regulations adopt a hypothetical sale approach. Thus, the income or loss realized by a partner from section 751 property upon the sale or exchange of its interest is the amount of income or loss that would have been allocated to the partner from section 751 property (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 fair market value immediately prior to the partner's transfer of the partnership interest.

## C. Section 755

### *In General*

The current regulations under section 755 contain a number of problems that prevent partnerships from allocating the section 743(b) basis adjustments to appropriate assets. The proposed regulations resolve these problems and implement the purposes of section 743(b) by focusing on the items that the transferee partner would receive upon a fair market value sale of all of the partnership's assets.

At the same time, the proposed regulations recognize that adjustments under section 734 differ significantly from adjustments under section 743. Specifically, adjustments under section 743(b) are intended to affect the transferee partner only. In contrast, adjustments under section 734 affect all of the partners. As a result, the proposed regulations under section 755 contain two separate regimes—one that applies to adjustments under section 734, and another that applies to adjustments under section 743. While the regime allocating adjustments under section 743 focuses on the transferee, the regime allocating adjustments under section 734 focuses on the difference between value and basis at the partnership entity level.

### *Allocating Adjustments under Section 743(b)*

The proposed regulations provide that allocations of basis adjustments under section 743 among partnership assets are made based on the amount of income, gain, or loss (including remedial allocations under §1.704-3(d)) that the transferee would be allocated if, immediately after the section 743(b) transfer, all of the partnership's assets were disposed of in a fully taxable transaction at fair market value. By adopting this method, in some situations the proposed regulations will require adjustments to be made that increase the basis of some assets and decrease the basis of others.

### *Hypothetical sale*

The current regulations do not take each partner's interest in specific assets into account. The amount of the section 743 adjustment is allocated among part-

nership properties to reduce the difference between the fair market value and the adjusted basis of partnership properties at the partnership entity level rather than at the partner level. This formulation of the rule fails to take into account special allocations or the varying treatment of different partners by virtue of the operation of section 704(c) or the minimum gain chargeback. Therefore, basis adjustments will often be made to the wrong assets, exposing the partners to tax consequences that may vary significantly from the partners' economic consequences.

Rather than attempt to define a partner's share of the basis or fair market value of a specific partnership asset, the proposed regulations focus on the actual tax items that would be allocated to the transferee in a fully taxable, fair market value sale. Under the proposed regulations, partnerships are required to adjust the basis of partnership assets in a manner that reflects the amount of income, gain, or loss that the transferee would recognize if all of the partnership's assets were sold in the hypothetical transaction.

### *Two-way Adjustments*

Under the current regulations, the partnership may not increase the basis of assets that have a fair market value in excess of basis and, at the same time, decrease the basis of assets that have a basis in excess of fair market value. Thus, if the section 743(b) adjustment is positive, the partnership may only increase the basis of assets that have a basis that is less than their fair market value. This restriction prevents the partnership from adjusting the basis of its assets in a manner that coordinates a transferee's tax consequences with its economic consequences.

The proposed regulations remove this restriction. Instead, the amount of the section 743 adjustment is viewed as a net adjustment. This net amount is then allocated between the partnership's two classes of assets (capital gain property and ordinary income property). The amount of the adjustment allocated to ordinary income property may be an increase while the amount of the adjustment allocated to capital gain property is a decrease. The amount of the adjustment al-

located to each class is then allocated among the assets within each class. The amount of the adjustment allocated to one item within the class may also be an increase even if the amount allocated to another item is a decrease.

#### *Allocation between Classes*

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 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 (i) the total amount of the basis adjustment under section 743, less (ii) the amount of the basis adjustment allocated to ordinary income; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis in capital gain property. In the event that a decrease in basis allocated to capital gain property exceeds the partnership's basis in capital gain property, the excess is applied to reduce the basis of ordinary income property.

#### *Allocation within Classes*

The amount of the basis adjustment allocated to each item of property within the class of ordinary income property equals:

(a) the amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee from the hypothetical sale of the item, minus

(b) the product of (1) any decrease to the amount of the basis adjustment to ordinary income property required because the partnership did not have enough basis in capital gain property to reduce, 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 items of the partnership's ordinary income property.

The amount of the basis adjustment allocated to each item of property within the class of capital gain property equals:

(a) the amount of income, gain, or loss (including any remedial allocations under

§1.704-3(d)) that would be allocated to the transferee 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 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 all items of 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 total fair market value of all of the partnership's items of capital gain property.

#### *Allocating Adjustments under Section 734*

As under the current regulations, the proposed regulations provide that allocations of section 734 adjustments among partnership assets are made based on the difference between the value of the property and the property's basis. 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. If there is an increase in basis to be allocated within a class of property, 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. 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).

#### *D. Section 1017*

Section 1017 provides rules concerning basis reductions resulting from a taxpayer's exclusion of cancellation of indebtedness income. In general, under §1.1017-1(f) of the proposed Income Tax Regulations, if a partner makes an election under section 108(b)(5) or section 108(c), the partner may treat a partnership interest as depreciable property (or depreciable real property) to the extent the partnership correspondingly reduces the partner's proportionate share of the adjusted basis of depreciable property (or depreciable real property) held by the partnership. These proposed regulations provide guidance regarding the determination of a partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property) and the consequences of the basis reductions required under sections 108 and 1017.

In general, these proposed regulations provide that a partner's share of the partnership's basis in depreciable property (or depreciable real property) equals the sum of (a) the partner's section 743(b) basis adjustment, if any, in the partnership items of depreciable property (or depreciable real property) and (b) the common basis depreciation deductions (not including remedial allocations of depreciation under §1.704-3(d)) that are reasonably expected to be allocated to the partner over the partnership property's remaining useful life. The amount of common basis depreciation deductions that a partner may reasonably expect to be allocated over the partnership property's useful life is based on all the facts and circumstances in effect at the time of the basis reduction. It is per se unreasonable, however, for the partnership to treat the same depreciation deductions as "reasonably expected" by more than one partner. Thus, the amount of the partners' total basis reductions under sections 108(b)(5) and 108(c) cannot exceed the partnership's basis in depreciable property (or depreciable real property).

The proposed regulations further provide that any reduction to the basis of depreciable property required under sections 108 and 1017 constitutes an adjustment to the basis of partnership property with respect to the partner only. These adjustments, therefore, are similar to the basis

adjustments required under section 743(b). Accordingly, the proposed regulations provide that these adjustments have the same effect and are recovered in the same manner as basis adjustments required under section 743(b); provided, however, that the election to treat the negative basis adjustment as an item of built-in gain (which decreases the amount of depreciation or amortization that the partnership may allocate) is not applicable. Consequently, if a partner's actual share of the partnership's common basis depreciation deductions in any year is less than the amount that was included in determining the partner's proportionate share of the partnership's common basis depreciation deductions for that year, the partner will recognize income.

#### E. Section 732

##### *In General*

With some exceptions, partners generally may receive distributions of partnership property without recognition of gain or loss. Rules are provided for determining the basis of the distributed property in the hands of the distributee. In the event that multiple properties are distributed by a partnership, section 732(c) provides allocation rules for determining their bases in the distributee partner's hands.

Section 732(c) was amended by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1061, 111 Stat. 788, 945-46 (1997). Under prior law, a partner's basis in its partnership interest was allocated among property distributed to the partner based on the distributed properties' adjusted bases. The rules allocated the partner's basis in its partnership interest first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the basis to be allocated was less than the partnership's basis, then in proportion to the partnership's basis). To the extent that there was any basis remaining to be allocated among distributed properties, the basis was allocated among the other properties in proportion to their adjusted bases to the partnership.

Section 1061 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1061, 111 Stat. 788, 945-46 (1997), revised the allocation rules for determining basis in the distributee partner's hands. As under

prior law, basis is allocated first to any distributed unrealized receivables and inventory items before it is allocated to any other distributed property. Basis is then allocated among the other distributed properties to the extent of each such property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustment already made). The proposed regulations amend the current regulations to incorporate these changes to section 732(c).

##### *Section 732(d)*

Section 732(d) provides a special rule that applies to determine the basis of property distributed to a transferee partner who acquired any part of its partnership interest in a transfer when an election under section 754 was not in effect. When the special rule applies, the basis of distributed property is adjusted immediately before the distribution to reflect the basis that the property would have had if the partnership had a section 754 election in effect at the time the transferee acquired the partnership interest. As a result, the basis of the distributed property in the hands of the partnership immediately before the distribution more closely approximates its fair market value. Consequently, the transferee's basis in the distributed property will also more closely approximate its fair market value.

Section 1.732-1(d)(4) of the current regulations requires transferees to apply the special basis rule in certain cases. Specifically, transferees are required to apply the special basis rule if at the time of the acquisition of the partnership interest—

(i) the fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership,

(ii) an allocation of basis under section 732(c) upon a liquidation of the partnership interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) a basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

The purpose of §1.732-1(d)(4) was to prevent distortions caused by section 732(c) that might inflate the basis of depreciable, depletable, or amortizable property above its fair market value. At the time that the regulations were adopted, such distortions might occur because section 732(c) allocated basis among distributed properties based on their relative bases. The changes made to section 732(c) by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1061, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. As a result, the Service and Treasury request comments on the proper scope of section 732(d), and specifically, under what circumstances, if any, the Secretary should exercise its authority to mandate the application of section 732(d) to a transferee.

##### *Proposed Effective Date*

The regulations are proposed to be effective (i) for all transfers of partnership interests on and after the date the regulations are published as final regulations in the Federal Register, (ii) for all distributions from partnerships on and after the date the regulations are published as final regulations in the Federal Register, and (iii) for all elections under sections 108(b)(5) and 108(c) made on or after the date the regulations are published as final regulations in the Federal Register.

##### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. An initial regulatory flexibility analysis has been prepared for the collection of information in this notice of proposed rulemaking under 5 U.S.C.

603. A summary of the analysis is set forth below under the heading "Summary of Initial Regulatory Flexibility Analysis." Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### *Summary of Initial Regulatory Flexibility Analysis*

This initial analysis is prepared pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6). In general, the proposed regulations require a transferee that acquires an interest in a partnership with an election under section 754 in effect, to notify the partnership of the transfer. This notification must include the name and taxpayer identification number of the transferee and the transferee's basis in the acquired partnership interest. The partnership is required to include a statement with its Form 1065, U.S. Partnership Return of Income for the taxable year in which the partnership acquires knowledge of the transfer. This statement must identify the name and taxpayer identification number of the transferee and the computation of the basis adjustment and the allocation of that adjustment to partnership properties. These requirements will ensure that the partnership has notice that a transfer has occurred and that the proper basis adjustments are computed. The legal basis for this requirement is contained in sections 743(b), 6001, 7805(a).

There were approximately 1,494,000 partnerships in 1994. However, these proposed regulations apply only to partnerships that have made an election under section 754. The election under section 754 is generally not made unless there has been a transfer of a partnership interest or a distribution by the partnership. Moreover, the effects of the election attach to specific items of partnership property and may provide only temporary benefits for the partners. The election also cannot be revoked without the consent of the Secretary. Accordingly, the Service and Treasury believe that most partnerships do not make the election under section 754. Therefore, most partnerships will not be affected by the proposed regulations in any given year.

After a partner conveys information to the partnership concerning a transfer of a partnership interest, the partnership must adjust the partner's interest in the basis of partnership property. Because these basis adjustments will affect the partner's share of depreciation or amortization deductions and amounts of gain or loss on the disposition of certain items of partnership property, the partnership must prepare and maintain special entries on its books. However, in many cases, partnership returns are prepared using computer software that can prepare and maintain these special entries after the initial year.

The IRS and Treasury Department are not aware of any federal rules that may duplicate, overlap, or conflict with the proposed rule.

As an alternative to the disclosure described above, the Service and Treasury considered, but rejected, a rule that would have required the partners, and not the partnerships, to make the basis reductions and to determine the effects of the basis adjustments on the partner's distributive shares. This alternative was rejected because the Service and Treasury believe that partnerships generally have better access to the information necessary to report section 743 basis adjustments properly. To require the partners rather than the partnerships to bear the burden of reporting would require the partnerships to provide the partners with significant amounts of information not otherwise needed by the partners. There are no known alternative rules that are less burdensome to the partnerships and their partners but that accomplish the purpose of the statute. The Service and Treasury request comments concerning possible alternatives.

#### *Comments and Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, July 8, 1998, at 10 a.m. in the IRS Auditorium of the Internal Revenue Building. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building

lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by April 29, 1998, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, June 24, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### *Drafting Information*

The principal authors of these proposed regulations are Brian M. Blum and Terri A. Belanger of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in their development.

#### *Partial Withdrawal of Notice of Proposed Rulemaking*

Accordingly, under the authority of 26 U.S.C. 7805, §1.168-2(n) in the notice of proposed rulemaking published February 16, 1984 (49 F.R. 5940) is withdrawn.

\* \* \* \* \*

#### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.168-2 also issued under 26 U.S.C. 168. \* \* \*

Section 1.732-1 also issued under 26 U.S.C. 732.

Section 1.732-2 also issued under 26 U.S.C. 732.

Section 1.734-1 also issued under 26 U.S.C. 734.

Section 1.743-1 also issued under 26 U.S.C. 743.



Section 1.751-1 also issued under 26 U.S.C. 751.

Section 1.755-1 also issued under 26 U.S.C. 755. \* \* \*

Section 1.1017-1 also issued under 26 U.S.C. 1017. \* \* \*

Par. 2. Section 1.732-1 is amended by revising paragraphs (c), (d)(1)(vi), (d)(4)(iii) and the last sentence in paragraph (d)(1)(v) and removing the undesig- nated text including the examples im- mediately following paragraph (d)(4)(iii) to read as follows:

*§1.732-1 Basis of distributed property other than money.*

\* \* \* \* \*

(c) *Allocation of basis among prop- erties distributed to a partner*—(1) *General rule*—(i) *Unrealized receivables and in- ventory items.* 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 immedi- ately 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 in- ventory items, the adjusted basis of the distributed property must be decreased in the manner provided in paragraph (c)(2)(i) of this section.

(ii) *Other distributed property.* Any basis not allocated to unrealized receiv- ables or inventory items under paragraph (c)(1)(i) 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 distribu- tion. However, if the sum of the adjusted bases to the partnership of such other dis- tributed property does not equal the basis to be allocated among the distributed prop- erty, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in paragraph (c)(2) of this section.

(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 un- realized depreciation before any decrease (but only to the extent of each property's unrealized depreciation). If the required decrease exceeds the amount of unreal- ized depreciation in the distributed prop- erty, the excess is allocated to the distrib- uted property in proportion to the adjusted bases of the distributed property, as ad- justed pursuant to the immediately pre- ceding 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 appreci- ation in proportion to each property's re- spective amount of unrealized appreci- ation before any increase (but only to the extent of each property's unrealized ap- preciation). If the required increase ex- ceeds the amount of unrealized appreci- ation in the distributed property, the excess is allocated to the distributed property (other than unrealized receivables or in- ventory items) in proportion to the fair market value of the distributed property.

(3) *Unrealized receivables and in- ventory 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 al- located, 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 fol- lowing examples:

*Example 1.* A is a one-fourth partner in partner- ship 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 value of \$400. Asset Y has an adjusted basis to the partnership and value of \$100. Neither Asset X nor Asset Y consists of in- ventory 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 allo- cated to the distributed property first in an amount equal to the property's adjusted basis to the partner- ship. 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. Fi- nally, the remaining basis, \$50, is allocated to Assets X and Y in proportion to their fair market values: \$40 to Asset X ( $400/500 \times \$50$ ), and \$10 to Asset Y ( $100/500 \times \$50$ ). 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 partner- ship 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 inter- est. Asset X has an adjusted basis to the partnership and fair market value of \$150. Asset Y has an ad- justed 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 de- crease of \$100 in the basis of the distributed prop- erty is required. Assets X and Y have unrealized de- preciation of zero and \$100, respectively. Thus, the entire decrease is allocated to Asset Y. After the dis- tribution, B has an adjusted basis of \$150 in Asset X and \$50 in Asset Y.

*Example 3.* C, a partner in partnership PRS, re- ceives a distribution in liquidation of its entire part- nership interest of \$6,000 cash, inventory items hav- ing 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 in- ventory 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 partner- ship 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 part- nership 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 remain- ing \$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 date.* This paragraph (c) applies to distributions of property from a partnership that occur on or after the date final regulations are published in the Fed- eral Register.

(d) \* \* \*  
(1) \* \* \*

(v) \* \* \* (For a shift of transferee's basis adjustment to like property, see §1.743-1(g).)

(vi) The provisions of this paragraph (d)(1) may be illustrated by the following example:

*Example.* (i) Transferee partner, T, purchased a one-fourth interest in partnership PRS for \$17,000. At the time T purchased the partnership interest, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of \$14,000 and a value of \$16,000. T's purchase price reflected \$500 of this difference. Thus, \$4,000 of the \$17,000 paid by T for the partnership interest was attributable to T's share of partnership inventory with a basis of \$3,500. Within 2 years after T acquired the partnership interest, T retired from the partnership and received in liquidation of its entire partnership interest the following property:

	Assets	
	Adjusted Basis to PRS	Market Value
Cash	\$1,500	\$1,500
Inventory	\$3,500	\$4,000
Asset X	\$2,000	\$4,000
Asset Y	\$4,000	\$5,000

(ii) The value of the inventory received by T was one-fourth of the value of all partnership inventory and was T's share of such property. It is immaterial whether the inventory T received was on hand when T acquired the interest. In accordance with T's election under section 732(d), the amount of T's share of partnership basis that is attributable to partnership inventory is increased by \$500 (one-fourth of the \$2,000 difference between the value of the property, \$16,000, and its \$14,000 basis to the partnership at the time T purchased its interest). This adjustment under section 732(d) applies only for purposes of distributions to T, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by T in the liquidating distribution is \$15,500 (\$17,000, T's basis for the partnership interest, reduced by the amount of cash received, \$1,500). This amount is allocated as follows: The basis of the inventory items received is \$4,000, consisting of the \$3,500 common partnership basis, plus the basis adjustment of \$500 which T would have had under section 743(b). The remaining basis of \$11,500 (\$15,500 minus \$4,000) is allocated among the remaining property distributed to T by assigning to each property the adjusted basis to the partnership of such property and adjusting that basis by any required increase or decrease. Thus, the adjusted basis to T of Asset X is \$5,111 (\$2,000, the adjusted basis of Asset X to the partnership, plus \$2,000, the amount of unrealized appreciation in Asset X, plus \$1,111 (\$4,000/9000 multiplied by \$2,500). Similarly, the adjusted basis of Asset Y to T is \$6,389 (\$4,000, the adjusted basis of Asset Y to the partnership, plus \$1,000, the amount of unrealized appreciation in Asset Y, plus, \$1,389 (\$5,000/\$9,000 multiplied by \$2,500).

\* \* \* \* \*

(4) \* \* \*  
 (iii) A basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

\* \* \* \* \*

Par. 3. Section 1.732-2 is amended by adding a new sentence at the end of the Example in paragraph (b) to read as follows:

*§1.732-2 Special partnership basis of distributed property.*

\* \* \* \* \*

(b) \* \* \*  
*Example.* \* \* \* See §1.743-1(g).

\* \* \* \* \*

Par. 4. In §1.734-1, paragraph (e) is added to read as follows:

*§1.734-1 Optional adjustment to basis of undistributed partnership property.*

\* \* \* \* \*

(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 the date final regulations are published in the Federal Register.

Par. 5. Section 1.743-1 is revised to read as follows:

*§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. 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; 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, as defined in paragraph (d)(2) of this section; 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, as defined in paragraph (d)(2) of this section.

(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. For example, if the partnership properly maintains capital accounts under the rules of §1.704-1(b)(2)(iv), the transferee's interest as a partner in the partnership's previously taxed capital is equal to—

(i) The transferee's capital account adjusted for the hypothetical transaction; 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; 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.

(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	Market Value
Cash	\$ 5,000	\$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	<u>20,000</u>	<u>40,000</u>
Total	\$55,000	\$76,000

	Liabilities and Capital	
	Adjusted per books	Market value
Liabilities	\$10,000	\$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	<u>15,000</u>	<u>22,000</u>
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 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 worth \$1,000 (Asset 1) with 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 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.

(f) *Subsequent transfers.* Where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. In the case of a gift of an interest in a partnership, the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to

the gifted partnership interest. The provisions of this paragraph (f) may be illustrated by the following example:

*Example.* (i) A, B, and C form partnership PRS. A and B each contribute \$1,000 cash and C contributes land with a basis and value of \$1,000. When the land has appreciated in value to \$1,300, A sells its interest to T1 for \$1,100 (one-third of \$3,300, the value of the partnership property). An election under section 754 is in effect; therefore, T1 has a basis adjustment of \$100.

(ii) After the land has further appreciated in value to \$1,600, T1 sells its interest to T2 for \$1,200 (one-third of \$3,600, the value of the partnership property). T2 has a basis adjustment of \$200. This amount is determined without regard to any basis adjustment that T1 may have had in the partnership assets.

(iii) During the following year, T2 makes a gift to T3 of fifty percent of T2's interest in PRS. At the time of the transfer, T2 has a \$200 basis adjustment. T2 is treated as transferring \$100 of the basis adjustment to T3 with the gift of the partnership interest.

(g) *Distributions—(1) Distribution of adjusted property to the transferee—(i) Coordination with section 732.* If a partnership distributes property to a transferee and the transferee has a basis adjustment for the property, the basis adjustment is taken into account under section 732. See §1.732-2(b).

(ii) *Coordination with section 734.* For certain adjustments to the common basis of remaining partnership property after the distribution of adjusted property to a transferee, see §1.734-2(b).

(2) *Distribution of adjusted property to another partner—(i) Coordination with section 732.* If a partner receives a distribution of property with respect to which another partner has a basis adjustment, the distributee does not take the basis adjustment into account under section 732.

(ii) *Reallocation of basis.* A transferee with a basis adjustment in property that is distributed to another partner reallocates the basis adjustment among the remaining items of partnership property pursuant to §1.755-1(c).

(3) *Distributions in complete liquidation of a partner's interest.* If a transferee receives a distribution of property (whether or not the transferee has a basis adjustment in such property) in liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the transferee's basis adjustment for the property in which the transferee relinquished an interest (ei-

ther because it remained in the partnership or was distributed to another partner). Any basis adjustment to property in which the transferee is deemed to relinquish its interest is reallocated among the properties distributed to the transferee under §1.755-1(c).

(4) *Coordination with other provisions.* The rules of sections 704(c)(1)(B), 731, 737, and 751 apply before the rules of this paragraph (g).

(5) *Example.* The provisions of this paragraph (g) are illustrated by the following example:

*Example.* (i) A, B, and C are equal partners in partnership PRS. Each partner originally contributed \$10,000 in cash, and PRS used the contributions to purchase five nondepreciable capital assets. PRS has no liabilities. After five years, PRS's balance sheet appears as follows:

	Assets	
	Adjusted Basis	Market Value
Asset 1 . . . . .	\$10,000	\$10,000
Asset 2 . . . . .	4,000	6,000
Asset 3 . . . . .	6,000	6,000
Asset 4 . . . . .	7,000	4,000
Asset 5 . . . . .	<u>3,000</u>	<u>13,000</u>
Total . . . . .	\$30,000	\$39,000

  

	Capital	
	Adjusted per books	Market Value
Partner A . . . . .	\$10,000	\$13,000
Partner B . . . . .	10,000	13,000
Partner C . . . . .	<u>10,000</u>	<u>13,000</u>
Total . . . . .	\$30,000	\$39,000

(ii) A sells its interest to T for \$13,000 when PRS has an election in effect under section 754. T receives a basis adjustment in the partnership property that is equal to \$3,000 (the excess of T's basis in the partnership interest, \$13,000, over T's share of the adjusted basis to the partnership of partnership property, \$10,000). The basis adjustment is allocated under section 755, and the partnership's balance sheet appears as follows:

	Assets		
	Adjusted Basis	Market Value	Basis Adjustment
Asset 1 . . . . .	\$10,000	\$10,000	\$ 0.00
Asset 2 . . . . .	4,000	6,000	666.67
Asset 3 . . . . .	6,000	6,000	0.00
Asset 4 . . . . .	7,000	4,000	(1,000.00)
Asset 5 . . . . .	<u>3,000</u>	<u>13,000</u>	<u>3,333.33</u>
Total . . . . .	\$30,000	\$39,000	\$3,000.00

  

	Capital		
	Adjusted per books	Market Value	Special Basis
Partner T . . . . .	\$10,000	\$13,000	\$3,000
Partner B . . . . .	10,000	13,000	0
Partner C . . . . .	<u>10,000</u>	<u>13,000</u>	<u>0</u>
Total . . . . .	\$30,000	\$39,000	\$3,000

(iii) Assume that PRS distributes Asset 2 to T in partial liquidation of T's interest in the partnership. T has a basis adjustment of \$666.67 in Asset 2. Under paragraph (g)(1)(i) of this section, T takes the basis adjustment into account under section 732. Therefore, T will have a basis in Asset 2 of \$4,666.67 following the distribution.

(iv) Assume instead that PRS distributes Asset 5 to C in complete liquidation of C's interest in PRS. T has a basis adjustment of \$3,333.33 in Asset 5. Under paragraph (g)(2)(i) of this section, C does not take T's basis adjustment into account under section 732. Therefore, the partnership's basis for purposes of sections 732 and 734 is \$3,000. Under paragraph (g)(2)(ii) of this section, T's \$3,333.33 basis adjustment is reallocated among the remaining partnership assets under §1.755-1(c).

(v) Assume instead that PRS distributes Asset 5 to T in complete liquidation of its interest in PRS. Under paragraph (g)(3) of this section, immediately prior to the distribution of Asset 5 to T, PRS must adjust the basis of Asset 5. Therefore, immediately prior to the distribution, PRS's basis in Asset 5 is equal to \$6,000, which is the sum of (A) \$3,000, PRS's common basis in Asset 5, plus (B) \$3,333.33, T's basis adjustment to Asset 5, plus (C) (\$333.33), the sum of T's basis adjustments in Assets 2 and 4. For purposes of sections 732 and 734, therefore, PRS will be treated as having a basis in Asset 5 equal to \$6,000.

(h) *Contributions of adjusted property—(1) Section 721(a) transactions.* If, in a transaction described in section 721(a), a partnership (the upper tier) contributes to another partnership (the lower tier) property with respect to which a basis adjustment has been made, the basis adjustment is treated as contributed to the lower tier, regardless of whether the lower tier partnership makes a section 754 election. The lower tier's basis in the contributed assets and the upper tier's basis in the partnership interest received in the transaction are determined with reference to the basis adjustment. However, that portion of the basis of the upper tier's interest in the lower tier attributable to the basis adjustment must be segregated and allocated solely to the transferee partner for whom the basis adjustment was made. Similarly, that portion of the lower tier's basis in its assets attributable to the basis adjustment must be segregated and allocated solely to the upper tier and the transferee. A partner with a basis adjustment in property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under §1.708-1(b)(1)(iv), regardless of whether the new partnership makes a section 754 election.

(2) *Section 351 transactions—(i) Basis in transferred property.* A corporation's adjusted tax basis in property transferred to the corporation by a partnership in a transaction described in section 351 is determined with reference to any basis adjustment to the property under section 743(b) (other than any basis adjustment that reduces a partner's gain under paragraph (h)(2)(ii) of this section).

(ii) *Partnership gain.* The amount of gain, if any, recognized by the partnership on a transfer of property by the partnership to a corporation in a transfer described in section 351 is determined without reference to any basis adjustment to the transferred property under section 743(b). The amount of gain, if any, recognized by the partnership on the transfer that is allocated to a partner with a basis adjustment in the transferred property is adjusted to reflect the partner's basis adjustment in the transferred property.

(iii) *Basis in stock.* The partnership's adjusted tax basis in stock received from a corporation in a transfer described in section 351 is determined without reference to the basis adjustment in property transferred to the corporation in the section 351 exchange. A partner with a basis adjustment in property transferred to the corporation, however, has a special basis adjustment in the stock received by the partnership in the section 351 exchange in an amount equal to the partner's basis adjustment in the transferred property, reduced by any basis adjustment that reduced the partner's gain under paragraph (h)(2)(ii) of this section.

(i) [Reserved].

(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 income, deduction, gain, loss, and distribution, 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 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 in-

come, 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 to the property that is the source of the item of partnership income, deduction, gain, or loss. These adjustments to the transferee's distributive shares do not affect the transferee's capital account.

(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 of gain or loss 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 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 that, under section 755, is allocated to the nondepreciable property. PRS then sells the property for \$60. PRS recognizes a book gain of \$10 and a tax loss of \$40. T will receive an allocation of \$40 of tax loss under the principles of section 704(c). 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 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 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). 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 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 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. 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.

(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.

(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 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) 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:

	A		B	
	Book	Tax	Book	Tax
Initial Contribution	\$500,000	\$100,000	\$500,000	\$500,000
Depreciation Year 1 Remedial	(30,000)		(30,000)	(20,000)
		<u>10,000</u>		<u>(10,000)</u>
	470,000	110,000	470,000	470,000
Depreciation Year 2 Remedial	(30,000)		(30,000)	(20,000)
		<u>10,000</u>		<u>(10,000)</u>
	<u>\$440,000</u>	<u>\$120,000</u>	<u>\$440,000</u>	<u>\$440,000</u>

(iii) 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.

(iv) 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) Effect on depreciation deductions—(1) Reduced deduction to transferee.* Except as provided in paragraph (j)(4)(ii)(A)(2) of this section, the amount of the basis adjustment 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.

(2) *Election to reduce deduction of other partners by excess adjustment.* The partnership may elect to treat the amount of the basis adjustment as an item of built-in gain, decreasing the amount of depreciation or amortization that the partnership may allocate for tax purposes. This elec-

tion has no effect on the depreciation or amortization of the property on the books of the partnership. The partnership must make this election on the statement required to be attached to its return pursuant to paragraph (k) of this section for the year that the adjustment is made to the item 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 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.

*Example 4.* (i) A and B are equal partners in partnership PRS. PRS has one depreciable asset that it purchased with cash. On the first day of a year, A transfers its interest to T at a time when the fair market value of the depreciable asset is \$50 and its adjusted tax basis is \$200. The partnership has an election in effect under section 754, resulting in a \$75 decrease in the basis of the depreciable asset to T under section 743.

(ii) The depreciable asset has a remaining useful life of two years and is being recovered using the straight-line method. The partnership elects, under paragraph (j)(4)(ii)(A)(2) of this section, to treat the decrease in basis under section 743 as an item of built-in gain, decreasing the amount of depreciation that the partnership can allocate from \$200 to \$125. This reduces the amount of depreciation available to be allocated to the partners in each year from \$100 to \$62.50. This election has no effect on the depreciation or amortization of the property on the books of the partnership. Therefore, the partnership will recover \$100 of depreciation on its books in each year.

(iii) At the end of the year, the partnership allocates each partner \$50 of depreciation for book purposes. Under the principles of section 704(c), the first \$50 of tax depreciation is allocated to B. The remaining \$12.50 of tax depreciation is allocated to T.

(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).

(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 oil 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 for the oil 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 oil 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).

(k) *Returns*—(1) *Statement of adjustments.* A partnership that must adjust the bases of partnership properties under section 743 must attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(2) *Requirement that transferee notify partnership*—(i) *Sale or exchange.* A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect, must notify the partnership, in writing, within 30 days of the sale or exchange (or, if earlier, by January 15 of the calendar year following the calendar year in which the sale or exchange occurred). The written notice to the partnership must include the names and addresses of both parties to the sale or exchange, the taxpayer identification numbers of the transferee and (if known) of the transferor, the date of the transfer, and the amount of any money and the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership.

(ii) *Transfer on death.* A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect, must notify the partnership, in writing, within one year of the death of the deceased partner. The written notice to the partnership must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014, and the manner in which the fair market value of the partnership interest was determined.

(3) *Reliance.* In making the adjustments under section 743 and any statement or return relating to such adjustments under this section, a partnership may rely on the written notice provided by a transferee pursuant to paragraph (k)(2) of this section to determine the transferee's basis in a partnership interest. The previous sentence shall not apply if the tax matters partner (as defined under section 6231(a)(7)) or any other partner

who has responsibility for federal income tax reporting by the partnership has knowledge of facts indicating that the statement is clearly erroneous.

(4) *Partnership not required to make or report adjustments under section 743 until it has notice of the transfer.* A partnership is not required to make the adjustments under section 743 (or any statement or return relating to those adjustments) with respect to any transfer until it has been notified of the transfer. For purposes of this section, a partnership is notified of a transfer when either—

(i) The partnership receives the written notice from the transferee required under paragraph (k)(2) of this section; or

(ii) The tax matters partner (as defined under section 6231(a)(7)) or any other partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

(5) *Effect on partnership of the failure of the transferee to comply.* If the transferee fails to provide the partnership with the written notice required by paragraph (k)(2) of this section, the partnership must attach a statement to its return in the year that the partnership is otherwise notified of the transfer. This statement must set forth the name and taxpayer identification number (if known) of the transferee. In addition, the following statement must be prominently displayed in capital letters on the first page of the partnership's return for such year, and on the first page of any schedule or information statement relating to such transferee's share of income, credits, deductions, etc.: "RETURN FILED PURSUANT TO §1.743-1(k)(5)." The partnership will then be entitled to report the transferee's share of partnership items without adjustment to reflect the transferee's basis adjustment in partnership property. If, following the filing of a return pursuant to this paragraph (k)(5), the transferee provides the applicable written notice to the partnership, the partnership must make such adjustments as are necessary to adjust the basis of partnership property (as of the date of the transfer) in any amended return otherwise to be filed by the partnership or in the next annual partnership return of income to be regularly filed by the partnership. At such time, the partnership must also provide the transferee with such informa-

tion as is necessary for the transferee to amend its prior returns to properly reflect the adjustment under section 743.

(1) *Effective date.* This section applies to transfers of partnership interests that occur on or after the date final regulations are published in the **Federal Register**.

Par. 6. Section 1.751-1 is amended by:

1. Revising paragraphs (a)(2) and (a)(3) and *Example 1* of paragraph (g).

2. Adding a sentence at the end of paragraph (f).

The addition and revisions read as follows:

*§1.751-1 Unrealized receivables and inventory items.*

(a) \* \* \*

(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 allocation 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 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.

(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.

\* \* \* \* \*

(f) \* \* \* The rules contained in paragraphs (a)(2) and (3) of this section apply to transfers of partnership interests that occur on or after the date final regulations are published in the Federal Register.

(g) \* \* \*

*Example 1.* (i) A and B are equal partners in personal service partnership PRS. B transfers its 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 Receivable . . . . .	10,000	10,000
Capital Assets . . . . .	7,000	5,000
Unrealized receivables . . . . .	<u>0</u>	<u>14,000</u>
Total . . . . .	20,000	32,000

	LIABILITIES AND CAPITAL	
	Adjusted Per books	Market Value
Liabilities . . . . .	\$ 2,000	\$ 2,000
Capital:		
A . . . . .	9,000	15,000
B . . . . .	<u>9,000</u>	<u>15,000</u>
Total . . . . .	20,000	32,000

(ii) None of the assets 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 half-interest in the partnership property includes a half-interest in the partnership's unrealized receivables items. B's basis for its partnership interest is \$10,000 (\$9,000, plus \$1,000, B's share of partnership liabilities). If section 751(a) did not apply to the sale, B would recognize \$6,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(iii) If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been 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 paragraph (a)(2) of this section (\$7,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a \$1,000 capital loss.

\* \* \* \* \*

Par. 7. Section 1.755-1 is revised to read as follows:

*§1.755-1 Rules for allocation of basis.*

(a) *Generally.* A partnership that has an election in effect under section 754 must

adjust the basis of partnership property under the provisions of section 734(b) and section 743(b) pursuant to the provisions of this section. The basis adjustment is first allocated between the two classes of property described in section 755(b). These classes of property consist of—

(1) Capital assets and section 1231(b) property (capital gain property); and

(2) Any other property of the partnership (ordinary income property). The portion of the basis adjustment allocated to each class is then allocated among the items within the class. Adjustments under section 743(b) are allocated under paragraph (b) of this section. Adjustments under section 734(b) are allocated under paragraph (c) of this section.

(b) *Adjustments under section 743(b)*—

(1) *Generally.* In general, the allocation of the basis adjustment under section 743 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 assets were disposed of in a fully taxable transaction for fair market value (the hypothetical transaction). 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. 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.

(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; 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 example:

*Example 1.* (i) A and B form equal partnership PRS. A contributes \$50,000 and Asset 1, a 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	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 .....	<u>10,000</u>	<u>2,500</u>
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 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	Market Value
Capital Gain Property:		
Asset 1 .....	\$ 500	\$ 750
Asset 2 .....	500	500
Ordinary Income Property:		
Asset 3 .....	\$ 500	\$ 250
Asset 4 .....	<u>500</u>	<u>500</u>
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, less (\$125), 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—

(I) 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—

(I) 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 total fair market value of all of the partnership's items of capital gain property.

(iii) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following example:

*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 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. The amount of the adjustment to Asset 1 is \$33,604 (the sum of \$37,500, less \$3,896 (\$10,000 × \$75,000/192,500)). The amount of the basis adjustment to Asset 2 is \$2,646 (the sum of \$8,750, less \$6,104 (\$10,000 × \$117,500/192,500)).

(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) *Increases 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) *Goodwill.* The application of the rules with respect to the allocation of an adjustment in basis under this paragraph (c) requires that a portion of the adjustment be allocated to partnership goodwill, to the extent that goodwill exists and is reflected in the value of the property distributed in accordance with the difference between such value of the goodwill and its adjusted basis at the time of the distribution.

(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, 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. None of the partnership's assets are section 751 property. The partner-

ship has an election in effect under section 754. After five years, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted Basis	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:		
Asset 4 . . . . .	\$ 40,000	\$ 45,000
Asset 5 . . . . .	50,000	60,000
Asset 6 . . . . .	<u>10,000</u>	<u>2,500</u>
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 \$37,500 in each of Assets 3 and 5. The distribution results in a \$12,500 increase in the basis of both capital gain property and ordinary income property.

(iii) *Allocation within classes*—(A) *Capital gain property.* The amount of the basis increase to capital gain property is \$12,500, and must be allocated among the remaining capital gain assets in proportion to the difference between the 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 \$9,260 (\$12,500, multiplied by \$50,000, divided by \$67,500), and the basis of Asset 2 will be increased by \$3,240 (\$12,500 multiplied by \$17,500, divided by \$67,500).

(B) *Ordinary income property.* The amount of the basis increase to ordinary income property is \$12,500, and must be allocated among the remaining ordinary income assets in proportion to the difference between the value and basis of each. Because the basis of Asset 6 exceeds its fair market value, no part of the basis adjustment will be allocated to Asset 6. The fair market value of Asset 4, \$45,000, exceeds its basis, \$40,000, by \$5,000. Because the partnership owns no other ordinary income property that has a value in excess of its basis, the entire basis adjustment will be allocated to Asset 4, increasing its basis from \$40,000 to \$52,500.

(d) *Effective date.* This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after the date final regulations are published in the Federal Register.

Par. 8. Section 1.1017-1 as proposed to be revised at 62 F.R. 958, January 7, 1997, is amended by:

1. Revising paragraph (f)(2)(iv).
2. Adding paragraph (f)(2)(v).

The addition and revision read as follows:

§1.1017-1 Basis reductions following a discharge of indebtedness.

\* \* \* \* \*

(f) \* \* \*

(2) \* \* \*

(iv) *Partner's share of partnership basis*—(A) *In general.* For purposes of this paragraph (f), a partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property) is equal to the sum of—

(1) The partner's section 743(b) basis adjustments to items of partnership depreciable property (or depreciable real property); and

(2) The common basis depreciation deductions (but not including remedial allocations of depreciation deductions under §1.704-3(d)) that, under the terms of the partnership agreement, are reasonably expected to be allocated to the partner over the property's remaining useful life. The assumptions made by a partnership in determining the reasonably expected allocation of depreciation deductions must be consistent for each partner. For example, a partnership may not treat the same depreciation deductions as being reasonably expected by more than one partner.

(B) *Effective date.* This paragraph (f)(2)(iv) applies to elections made under sections 108(b)(5) and 108(c) on or after the date the regulations are published as final regulations in the Federal Register.

(v) *Treatment of basis reduction*—(A) *Basis adjustment.* The amount of the reduction to the basis of depreciable partnership property constitutes an adjustment to the basis of partnership property with respect to the partner only. No adjustment is made to the common basis of partnership property. Thus, for purposes of income, deduction, gain, loss, and distribution, the partner will have a special basis for those partnership properties the bases of which are adjusted under section 1017 and this section.

(B) *Recovery of adjustments to basis of partnership property.* Adjustments to the basis of partnership property under this section are recovered in the manner described in §1.743-1.

(C) *Effect of basis reduction.* Adjustments to the basis of partnership property under this section are treated in the same manner and have the same effect as an

adjustment to the basis of partnership property under section 743, provided, however, that the election in §1.743-1(j)-(4)(ii)(A)(2) is not available. The following example illustrates this paragraph (f)(2)(v):

*Example.* (i) A, B, and C are equal partners in partnership PRS, which owns (among other things) Asset 1, an item of depreciable property with a basis of \$30,000. A's basis in its partnership interest is \$20,000. Under the terms of the partnership agreement, A's share of the depreciation deductions from Asset 1 over its remaining useful life will be \$10,000. Under section 1017, A requests, and PRS agrees to decrease the basis of Asset 1 with respect to A by \$10,000.

(ii) In the year following the reduction of basis under section 1017, PRS amends its partnership agreement to provide that items of depreciation and loss from Asset 1 will be allocated equally between B and C. In that year, A's distributive share of the partnership's common basis depreciation deductions from Asset 1 is now \$0. Under §1.743-1(j)(4)-(ii)(B), the amount of the section 1017 basis adjustment that A recovers during the year is \$1,000. A will report \$1,000 of ordinary income because A's distributive share of the partnership's common basis depreciation deductions from Asset 1 (\$0) is insufficient to offset the amount of the section 1017 basis adjustment recovered by A during the year (\$1,000).

(iii) In the following year, PRS sells Asset 1 for \$15,000 and recognizes a \$12,000 loss. This loss is allocated equally between B and C, and A's share of the loss is \$0. Upon the sale of Asset 1, A recovers its entire remaining section 1017 basis adjustment (\$9,000). A will report \$9,000 of ordinary income.

(D) *Effective date.* This paragraph (f)(2)(v) applies to elections made under sections 108(b)(5) and 108(c) on or after the date the regulations are published as final regulations in the Federal Register.

\* \* \* \* \*

Michael P. Dolan,  
Deputy Commissioner of  
Internal Revenue.

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