

Internal Revenue Service, Treasury

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under paragraph (k)(2) of this section; or

(ii) Any 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 ascertainable) 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 information as is necessary for the transferee to amend its prior returns to properly reflect the adjustment under section 743(b).

(1) *Effective date.* This section applies to transfers of partnership interests that occur on or after December 15, 1999.

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PROVISIONS COMMON TO PART II,
SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.751-1 Unrealized receivables and inventory items.

(a) *Sale or exchange of interest in a partnership—(1) Character of amount realized.* To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated substantially in value", see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) *Determination of gain or loss.* The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under §1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest. See §1.460-4(k)(2)(iv)(E) for rules relating to

the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting.

(3) *Statement required.* A partner selling or exchanging any part of an interest in a partnership that has any section 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information—

- (i) The date of the sale or exchange;
- (ii) The amount of any gain or loss attributable to the section 751 property; and
- (iii) The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

(b) *Certain distributions treated as sales or exchanges—*(1) *In general.* (i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such

property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of \$100,000 in which partner A has an interest of 30 percent, or \$30,000. If A receives \$20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the \$80,000 of section 751 property remaining in the partnership after the distribution, only \$6,000 (\$30,000 minus \$24,000 (30 percent of \$80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining \$14,000 (\$20,000 minus \$6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) *Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).* (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value

of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) *Distribution of partnership property other than section 751 property.* (i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character

of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) *Exceptions.* (i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section

751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736-1.

(5) *Statement required.* A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) *Unrealized receivables.* (1) The term *unrealized receivables*, as used in subchapter K, chapter 1 of the Code, means any rights (contractual or otherwise) to payment for:

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or dis-

tribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)(i) With respect to any taxable year of a partnership ending after September 12, 1966 (but only in respect of expenditures paid or incurred after that date), the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from mining property defined in section 617(f)(2). With respect to each item of partnership mining property so defined, the potential gain is the amount that would be treated as gain to which section 617(d)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(ii) With respect to sales, exchanges, or other dispositions after December 31, 1975, in any taxable year of a partnership ending after that date, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in a DISC as described in section 992(a). With respect to stock in such a DISC, the potential gain is the amount that would be treated as gain to which section 995(c) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(iii) With respect to any taxable year of a partnership beginning after December 31, 1962, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1245 property. With respect to each item of partnership section 1245 property (as defined in section 1245(a)(3)), potential gain from section 1245 property is the amount that would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See § 1.1245-1(e)(1). For example, if a partnership would recognize under section 1245(a)(1) gain of \$600 upon a sale of one item of section 1245 property and gain of \$300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be \$900.

(iv) With respect to transfers after October 9, 1975, and to sales, exchanges, and distributions taking place after that date, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in certain foreign corporations as described in section 1248. With respect to stock in such a foreign corporation, the potential gain is the amount that would be treated as gain to which section 1248(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(v) With respect to any taxable year of a partnership ending after December 31, 1963, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1250 property. With respect to each item of partnership section 1250 property (as defined in section 1250(c)), potential gain from section 1250 property is the amount that would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partner-

ship at its fair market value. See § 1.1250-1(f)(1).

(vi) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm recapture property as defined in section 1251(e)(1) (as in effect before enactment of the Tax Reform Act of 1984). With respect to each item of partnership farm recapture property so defined, the potential gain is the amount which would be treated as gain to which section 1251(c) (as in effect before enactment of the Tax Reform Act of 1984) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(vii) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm land as defined in section 1252(a)(2). With respect to each item of partnership farm land so defined, the potential gain is the amount that would be treated as gain to which section 1252(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(viii) With respect to transactions which occur after December 31, 1976, in any taxable year of a partnership ending after that date, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from franchises, trademarks, or trade names referred to in section 1253(a). With respect to each such item so referred to in section 1253(a), the potential gain is the amount that would be treated as gain to which section 1253(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the items were sold by the partnership at its fair market value.

(ix) With respect to any taxable year of a partnership ending after December 31, 1975, the term *unrealized receivables*,

for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain under section 1254(a) from natural resource recapture property as defined in § 1.1254-1(b)(2). With respect to each separate partnership natural resource recapture property so described, the potential gain is the amount that would be treated as gain to which section 1254(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the property were sold by the partnership at its fair market value.

(5) For purposes of subtitle A of the Internal Revenue Code, the basis of any potential gain described in paragraph (c)(4) of this section is zero.

(6)(i) If (at the time of any transaction referred to in paragraph (c)(4) of this section) a partnership holds property described in paragraph (c)(4) of this section and if—

(A) A partner had a special basis adjustment under section 743(b) in respect of the property;

(B) The basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d); or

(C) On the date a partner acquired a partnership interest by way of a sale or exchange (or upon the death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, the partner's share of any potential gain described in paragraph (c)(4) of this section is determined under paragraph (c)(6)(ii) of this section.

(ii) The partner's share of the potential gain described in paragraph (c)(4) of this section in respect of the property to which this paragraph (c)(6)(ii) applies is that amount of gain that the partner would recognize under section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c) (as in effect before the Tax Reform Act of 1984), 1252(a), 1253(a), or 1254(a) (as the case may be) upon a sale of the property by the partnership, except that, for purposes of this paragraph (c)(6) the partner's share of such gain is determined in a manner that is consistent with the manner in which the partner's share of partnership property is determined; and the amount of

a potential special basis adjustment under section 732(d) is treated as if it were the amount of a special basis adjustment under section 743(b). For example, in determining, for purposes of this paragraph (c)(6), the amount of gain that a partner would recognize under section 1245 upon a sale of partnership property, the items allocated under § 1.1245-1(e)(3)(ii) are allocated to the partner in the same manner as the partner's share of partnership property is determined. See § 1.1250-1(f) for rules similar to those contained in § 1.1245-1(e)(3)(ii).

(d) *Inventory items which have substantially appreciated in value*—(1) *Substantial appreciation*. Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms “inventory items which have appreciated substantially in value” or “substantially appreciated inventory items” refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the “fair market value” of inventory items has the same meaning as “market” value in

the regulations under section 471, relating to general rule for inventories.

(2) *Inventory items.* The term *inventory items* as used in subchapter K, chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivision (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) *Section 751 property and other property.* For the purposes of this section, *section 751 property* means unrealized receivables or substantially appreciated inventory items, and *other property* means all property (including money) except section 751 property.

(f) *Effective date.* Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of subchapter K, chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6

months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of §1.771-1. See also section 771(c) and paragraph (c) of §1.771-1. The rules contained in paragraphs (a)(2) and (a)(3) of this section apply to transfers of partnership interests that occur on or after December 15, 1999.

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

Example 1. (i)(A) 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	Fair market value
Cash	\$3,000	\$3,000
Loans Receivable	10,000	10,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

	Liabilities and Capital	
	Adjusted per books	Fair market value
Liabilities	\$2,000	\$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

(B) None of the assets owned by PRS is section 704(c) property, and the capital assets are nondepreciable. 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.

(ii) 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.

Example 2. (a) Facts. Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

ASSETS		
	Adjusted basis per books	Market value
Cash	\$15,000	\$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000
Total	96,000	11,000

LIABILITIES AND CAPITAL		
	Per books	Value
Current liabilities	\$15,000	\$15,000
Mortgage payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of \$10,000 cash and depreciable property with a fair market value of \$15,000 and an adjusted basis to the partnership of \$15,000.

(b) *Presence of section 751 property.* The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, \$39,000 (inventory \$30,000, and accounts receivable \$9,000), exceeds 120 percent of the \$30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, \$39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of \$96,000 or \$9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because

the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash (\$5,000) and \$15,000 in depreciable property (\$1,000 less than his \$16,000 share). In addition, he received other partnership property (\$5,000 cash and \$12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable (\$3,000), inventory (\$10,000), land (\$3,000), and the balance of his interest in depreciable property (\$1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of \$13,000 (\$3,000 in accounts receivable and \$10,000 in inventory). Thus, \$13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is \$10,000 (\$7,000 for inventory and \$3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for \$13,000. Thus, on the sale of his share of inventory items, C realizes \$3,000 of ordinary income.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was \$32,000 (\$20,000 plus \$12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by \$10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of \$22,000 for the remainder of his partnership interest. The total distribution to C was \$37,000 (\$22,000 in cash and liabilities assumed, and \$15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and \$9,000 in money (\$22,000 less \$13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's

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basis for the depreciable property is \$13,000 (the remaining basis of his partnership interest, \$22,000, reduced by \$9,000, the money received in the distribution).

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the \$22,000 money distributed (in cash and the assumption of C's share of liabilities), \$13,000 was paid to acquire C's interest in inventory (\$10,000 fair market value) and in accounts receivable (\$3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is \$13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable (\$30,000) by \$10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by \$13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from \$21,000 to \$24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of § 1.732-1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: \$15,000 in depreciable property (with a basis to the partnership of \$15,000) and \$9,000 in money (\$22,000 less \$13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property

before the distribution, \$42,000, is reduced by the basis of the depreciable property distributed, \$15,000, leaving a basis for the depreciable property in the partnership of \$27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been \$15,000, and is only \$13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by \$2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be \$38,000 (\$20,000 original contribution, plus \$12,000, each partner's original share of the liabilities, plus \$6,000, the share of C's liabilities each assumed).

(f) *Partnership trial balance.* A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

Example 3. (a) Facts. Assume that the distribution to partner C in example 2 of this paragraph in liquidation of his entire interest in partnership ABC consists of \$5,000 in cash and \$20,000 worth of partnership inventory with a basis of \$14,000.

	I		II	
	Sec.754, Election in effect		Sec.754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	\$5,000	\$5,000	\$5,000	\$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
.....	20,000	25,000	20,000	25,000
.....	20,000	25,000	20,000	25,000

		I		II	
		Sec.754, Election in effect		Sec.754, Election not in effect	
		Basis	Fair market value	Basis	Fair market value
		76,000	86,000	76,000	86,000

(b) *Presence of section 751 property.* For the same reason as stated in paragraph (b) of example 2, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* In the distribution, C received his share of cash (\$5,000) and his share of appreciated inventory items (\$13,000). In addition, he received appreciated inventory with a fair market value of \$7,000 (and with an adjusted basis to the partnership of \$4,900) and \$12,000 in money (liabilities assumed). C has relinquished his interest in \$16,000 of depreciable property and \$3,000 of land. Although C relinquished his interest in \$3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., depreciable property or land for inventory items). Assume that the partners agree that the \$7,000 of inventory in excess of C's share was received by him in exchange for \$7,000 of depreciable property.

(d) *Distributee partner's tax consequences.* C's tax consequence on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is \$6,125 (42,000/48,000 of \$7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for \$7,000, realizing a gain of \$875.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was \$32,000 (\$20,000, plus \$12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by \$6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of \$25,875 for the remainder of his partnership interest. Of the \$37,000 total distribution to C, \$30,000 (\$17,000 in money, including liabilities assumed, and \$13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of \$13,000 (which had an adjusted basis to the partnership of \$9,100) is limited to \$8,875, the amount of the remaining basis for his partnership interest, \$25,875, reduced by \$17,000, the money

received. Thus, C's total aggregate basis for the inventory received is \$15,875 (\$7,000 plus \$8,875), and not its \$14,000 basis in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has \$2,100 of ordinary income on the sale of the \$7,000 of inventory which had a basis to the partnership of \$4,900 (21,000/30,000 of \$7,000). This \$7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is \$42,875 (\$42,000 less \$6,125, the basis of the 7/16ths share considered as distributed to C, plus \$7,000, the partnership purchase price for this share).

(2) *The part of the distribution not under section 751 (b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been \$9,100, and C's basis for such inventory after distribution is only \$8,875. The basis of the inventory remaining in the partnership must be increased by \$225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be \$39,050 (\$20,000 original contribution, plus \$12,000, each partner's original share of the liabilities, plus \$6,000, the share of C's liabilities now assumed, plus \$1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example 4. (a) Facts. Assume the same facts as in example 3 of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the \$7,000 of inventory which he received in excess of his share.

(b) *Presence of section 751 property.* For the same reasons stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* The analysis stated in paragraph (c) of example 3 of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate

amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received \$7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. (\$7,000, fair market value of property released, over \$19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is \$6,263 (51,000/57,000 of \$7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for \$7,000, realizing a gain of \$737.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was \$32,000 (\$20,000 plus \$12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by \$6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of \$25,737 for the remainder of his partnership interest. Of the total \$37,000 distributed to C, \$30,000 (\$17,000 in money, including liabilities assumed, and \$13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory (with a fair market value of \$13,000 and an adjusted basis to the partnership of \$9,100) is limited to \$8,737, the amount of the remaining basis for his partnership interest (\$25,737 less \$17,000, money received). Thus, C's total aggregate basis for the inventory he received is \$15,737 (\$7,000 plus \$8,737), and not the \$14,000 basis it had in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has \$2,100 of ordinary income on the sale of \$7,000 of inventory which had a basis to the partnership of \$4,900 (21,000/30,000 of \$7,000). This \$7,000 of inventory was paid to acquire 7/19ths of C's interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be \$42,737 and \$9,000, respectively. The basis for the de-

preciable property is computed as follows: The common partnership basis of \$42,000 is reduced by the \$5,158 basis (42,000/48,000 of \$5,895) for C's 7/19ths interest constructively distributed and increased by \$5,895 (16,000/19,000 of \$7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The \$9,000 original partnership basis is reduced by \$1,105 basis (\$9,000/9,000 of \$1,105) of land constructively distributed to C, and increased by \$1,105 (3,000/19,000 of \$7,000), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been \$9,100 and C's basis for such inventory after the distribution is only \$8,737. The basis of the inventory remaining in the partnership must be increased by the difference of \$363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be \$39,050 (\$20,000 original contribution plus \$12,000, each partner's original share of the liabilities, plus \$6,000, the share of C's liabilities assumed, plus \$1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example 5. (a) *Facts.* Assume that partner C in example 2 of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of \$5,000 in cash, and \$7,500 of accounts receivable with a basis to the partnership of \$7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by \$4,800 from \$12,000 (1/3 of \$36,000) to \$7,200 (1/5 of \$36,000).

(b) *Presence of section 751 property.* For the same reasons as stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Item	C's interest Fair Market Value		C received		C relinquished
	One-third before	One-fifth after	Distribution of share	In excess of share	
Cash	\$5,000	\$2,000	\$3,000	\$2,000	.....
Liabilities assumed	(12,000)	(7,200)	.....	4,800	.....
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	.....
Inventory	10,000	6,000	.....	.....	\$4,000
Depreciable property	16,000	9,600	.....	.....	6,400
Land	3,000	1,800	.....	.....	1,200
Total	25,000	12,500	5,700	11,600	11,600

Although C relinquished his interest in \$4,000 of inventory and received \$4,800 of accounts receivable, both items constitute section 751 property and C has received only \$800 of accounts receivable for \$800 worth of depreciable property or for an \$800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received \$800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining \$6,700 of accounts receivable are received in a current distribution.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* Assuming that the partners paid \$800 worth of accounts receivable for \$800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the \$800 worth of depreciable property is \$700 (42,000/48,000 of \$800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his \$800 share of depreciable property to the partnership for \$800. On the sale of the depreciable property, C realizes a gain of \$100. If, on the other hand, the partners had agreed that C exchanged an \$800 interest in the land for \$800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be \$800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be \$716 (51,000/57,000 of \$800). In that case, on the sale of the balance of the \$800 share of depreciable property and land, C would realize \$84 of gain (\$800 less \$716).

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to

the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	\$32,000	\$32,000	\$32,000
Less basis of property distributed prior to sec. 751 (b) sale or exchange	- 700	- 800	- 716
	31,300	31,200	31,284
Less money received in distribution	- 9,800	- 9,800	- 9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under sec. 732	- 6,700	- 6,700	- 6,700
Resulting basis for C's interest	14,800	14,700	14,784

C's basis for the \$1,500 worth of accounts receivable which he received in the distribution will be \$7,500, composed of \$800 for the portion purchased in the section 751(b) exchange, plus \$6,700, the basis carried over under section 732(a) for the portion received in the current distribution.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of \$800 for the accounts receivable for which it received \$800 worth of other property. If the partnership agreed to purchase \$800 worth of depreciable property, the partnership basis of depreciable property becomes \$42,100 (\$42,000 less \$700 basis of property constructively distributed to C, plus \$800, price of property purchased). If the

partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be \$51,084 (depreciable property, \$42,084 and land \$9,000). The basis for the depreciable property is computed as follows: The common partnership basis of \$42,000 is reduced by the \$590 basis (42,000/48,000 of \$674) for C's \$674 interest constructively distributed, and increased by \$674 (6,400/7,600 of \$800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The \$9,000 original partnership basis is reduced by \$126 basis (9,000/9,000 of \$126) of the land constructively distributed to C, and increased by \$126 (1,200/7,600 of \$800), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751(b).* The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

Example 6. (a) *Facts.* Partnership ABC distributes to partner C, in liquidation of his entire one-third interest in the partnership, a machine which is section 1245 property with a recomputed basis (as defined in section 1245(a)(2)) of \$18,000. At the time of the distribution, the balance sheet of the partnership is as follows:

ASSETS		
	Adjusted basis per books	Market value
Cash	\$3,000	\$3,000
Machine (section 1245 property) ..	9,000	15,000
Land	18,000	27,000
Total	30,000	45,000

LIABILITIES AND CAPITAL		
	Per books	Value
Liabilities	\$0	\$0
Capital:		
A	10,000	15,000
B	10,000	15,000
C	10,000	15,000
Total	30,000	45,000

(b) *Presence of section 751 property.* The section 1245 property is an unrealized receivable of the partnership to the extent of the potential section 1245 income in respect of the

property. Since the fair market value of the property (\$15,000) is lower than its recomputed basis (\$18,000), the excess of the fair market value over its adjusted basis (\$9,000), or \$6,000, is the potential section 1245 income of the partnership in respect of the property. The partnership has no other section 751 property.

(c) *The properties exchanged.* In the distribution C received his share of section 751 property (potential section 1245 income of \$2,000, i.e., 1/3 of \$6,000) and his share of section 1245 property (other than potential section 1245 income) with a fair market value of \$3,000, i.e., 1/3 of (\$15,000 minus \$6,000), and an adjusted basis of \$3,000, i.e., 1/3 of \$9,000. In addition he received \$4,000 of section 751 property (consisting of \$4,000 (\$6,000 minus \$2,000) of potential section 1245 income) and section 1245 property (other than potential section 1245 income) with a fair market value of \$6,000 (\$9,000 minus \$3,000) and an adjusted basis of \$6,000 (\$9,000 minus \$3,000). C relinquished his interest in \$1,000 of cash and \$9,000 of land. Assume that the partners agree that the \$4,000 of section 751 property in excess of C's share was received by him in exchange for \$4,000 of land.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he received in a current distribution 4/9ths of his share of the land with a basis of \$2,667 (18,000/27,000×\$4,000). Then C is considered as having sold his 4/9ths share of the land to the partnership for \$4,000, realizing a gain of \$1,333. C's basis for the remainder of his partnership interest after the current distribution is \$7,333, i.e., the basis of his partnership interest before the current distribution (\$10,000) minus the basis of the land treated as distributed to him (\$2,667).

(2) *The part of the distribution not under section 751(b).* Of the \$15,000 total distribution to C, \$11,000 (\$2,000 of potential section 1245 income and \$9,000 section 1245 property other than potential section 1245 income) is not within section 751(b). Under section 732(b) and (c), C's basis for his share of potential section 1245 income is zero (see paragraph (c)(5) of this section) and his basis for \$9,000 of section 1245 property (other than potential section 1245 income) is \$7,333, i.e., the amount of the remaining basis for his partnership interest (\$7,333) reduced by the basis for his share of potential section 1245 income (zero). Thus C's total aggregate basis for the section 1245 property (fair market value of \$15,000) distributed to him is \$11,333 (\$4,000 plus \$7,333). For an illustration of the computation of his recomputed basis for the section 1245 property immediately after the distribution, see example 2 of paragraph (f)(3) of §1.1245-4.

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(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* Upon the sale of \$4,000 potential section 1245 income, with a basis of zero, for 4/9ths of C's interest in the land, the partnership consisting of the remaining members has \$4,000 ordinary income under sections 751(b) and 1245(a)(1). See section 1245(b)(3) and (6)(A). The partnership's new basis for the land is \$19,333, i.e., \$18,000, less the basis of the 4/9ths share considered as distributed to C (\$2,667), plus the partnership purchase price for this share (\$4,000).

(2) *The part of the distribution not under section 751(b).* The analysis under this subparagraph should be made in accordance with the principles illustrated in paragraph (e)(2) of examples 3, 4, and 5 of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8575, July 7, 1965; T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 8586, 60 FR 2500, Jan. 10, 1995; T.D. 8847, 64 FR 69915, Dec. 15, 1999; T.D. 9137, 69 FR 42559, July 16, 2004]

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 - (1) In general.
 - (2) Election to apply this section to assumptions of liabilities occurring after October 18, 1999 and before June 24, 2003.
 - (i) In general.
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 - (iv) Time for making election.

[T.D. 8380, 56 FR 66350, Dec. 23, 1991, as amended by T.D. 9207, 70 FR 30342, May 26, 2005]

§ 1.752-1 Treatment of partnership liabilities.

(a) *Definitions.* For purposes of section 752, the following definitions apply:

(1) *Recourse liability defined.* A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2.

(2) *Nonrecourse liability defined.* A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under § 1.752-2.

(3) *Related person.* Related person means a person having a relationship

to a partner that is described in § 1.752-4(b).

(4) *Liability defined*—(i) *In general.* An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation—

(A) Creates or increases the basis of any of the obligor's assets (including cash);

(B) Gives rise to an immediate deduction to the obligor; or

(C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

(ii) *Obligation.* For purposes of this paragraph and § 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.

(iii) *Other liabilities.* For obligations that are not § 1.752-1 liabilities, see §§ 1.752-6 and 1.752-7.

(iv) *Effective date.* Except as otherwise provided in § 1.752-7(k), this paragraph (a)(4) applies to liabilities that are incurred or assumed by a partnership on or after June 24, 2003.

(b) *Increase in partner's share of liabilities.* Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership.

(c) *Decrease in partner's share of liabilities.* Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.

(d) *Assumption of liability.* Except as otherwise provided in paragraph (e) of

this section, a person is considered to assume a liability only to the extent that:

(1) The assuming person is personally obligated to pay the liability; and

(2) If a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.

(e) *Property subject to a liability.* If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.

(f) *Netting of increases and decreases in liabilities resulting from same transaction.* If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability or the termination of the partnership under section 708(b) will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction. When two or more partnerships merge or consolidate under section 708(b)(2)(A), as described in § 1.708-1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the

terminating partnership and the re-terminating partnership to determine the effect of the merger under section 752.

(g) *Example.* The following example illustrates the principles of paragraphs (b), (c), (e), and (f) of this section.

Example 1. Property contributed subject to a liability; netting of increase and decrease in partner's share of liability. B contributes property with an adjusted basis of \$1,000 to a general partnership in exchange for a one-third interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of \$150 and has a fair market value in excess of \$150. After the contribution, B remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under paragraph (e) of this section, the partnership is treated as having assumed the \$150 liability. As a result, B's individual liabilities decrease by \$150. At the same time, however, B's share of liabilities of the partnership increases by \$150. Only the net increase or decrease in B's share of the liabilities of the partnership and B's individual liabilities is taken into account in applying section 752. Because there is no net change, B is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership under paragraph (b) or (c) of this section. Therefore B's basis for B's partnership interest is \$1,000 (B's basis for the contributed property).

Example 2. Merger or consolidation of partnerships holding property encumbered by liabilities. (i) B owns a 70 percent interest in partnership T. Partnership T's sole asset is property X, which is encumbered by a \$900 liability. Partnership T's adjusted basis in property X is \$600, and the value of property X is \$1,000. B's adjusted basis in its partnership T interest is \$420. B also owns a 20 percent interest in partnership S. Partnership S's sole asset is property Y, which is encumbered by a \$100 liability. Partnership S's adjusted basis in property Y is \$200, the value of property Y is \$1,000, and B's adjusted basis in its partnership S interest is \$40.

(ii) Partnership T and partnership S merge under section 708(b)(2)(A). Under section 708(b)(2)(A) and § 1.708-1(c)(1), partnership T is considered terminated and the resulting partnership is considered a continuation of partnership S. Partnerships T and S undertake the form described in § 1.708-1(c)(3)(i) for the partnership merger. Under § 1.708-1(c)(3)(i), partnership T contributes property X and its \$900 liability to partnership S in exchange for an interest in partnership S. Immediately thereafter, partnership T distributes the interests in partnership S to its

partners in liquidation of their interests in partnership T. B owns a 25 percent interest in partnership S after partnership T distributes the interests in partnership S to B.

(iii) Under paragraph (f) of this section, B nets the increases and decreases in its share of partnership liabilities associated with the merger of partnership T and partnership S. Before the merger, B's share of partnership liabilities was \$650 (B had a \$630 share of partnership liabilities in partnership T and a \$20 share of partnership liabilities in partnership S immediately before the merger). B's share of S's partnership liabilities after the merger is \$250 (25 percent of S's total partnership liabilities of \$1,000). Accordingly, B has a \$400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a \$400 distribution from partnership S under section 752(b). Because B's adjusted basis in its partnership S interest before the deemed distribution under section 752(b) is \$460 (\$420 + \$40), B will not recognize gain under section 731. After the merger, B's adjusted basis in its partnership S interest is \$60.

(h) *Sale or exchange of a partnership interest.* If a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder. For example, if a partner sells an interest in a partnership for \$750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of \$250, the seller realizes \$1,000 on the transaction.

(i) *Bifurcation of partnership liabilities.* If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991, as amended by T.D. 8925, 66 FR 723, Jan. 4, 2001; T.D. 9207, 70 FR 30343, May 26, 2005]

§ 1.752-2 Partner's share of recourse liabilities.

(a) *In general.* A partner's share of a recourse partnership liability equals the portion of that liability, if any, for

which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (k) of this section.

(b) *Obligation to make a payment*—(1)

In general. Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

(i) All of the partnership's liabilities become payable in full;

(ii) With the exception of property contributed to secure a partnership liability (see §1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero;

(iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors's right to repayment is limited solely to one or more assets of the partnership);

(iv) All items of income, gain, loss, or deduction are allocated among the partners; and

(v) The partnership liquidates.

(2) *Treatment upon deemed disposition.* For purposes of paragraph (b)(1) of this section, gain or loss on the deemed disposition of the partnership's assets is computed in accordance with the following:

(i) If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent section 704(c) or §1.704-1(b)(4)(i) applies) in those assets.

(ii) A loss is recognized equal to the remaining tax basis (or book value to the extent section 704(c) or §1.704-1(b)(4)(i) applies) of all the partnership's assets not taken into account in paragraph (b)(2)(i) of this section.

(3) *Obligations recognized.* The determination of the extent to which a partner or related person has an obligation to make a payment under paragraph (b)(1) of this section is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including:

(i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;

(ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

(iii) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), paragraph (b) of this section is applied as if the obligation did not exist.

(4) *Contingent obligations.* A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

(5) *Reimbursement rights.* A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is

entitled to reimbursement from another partner or a person who is a related person to another partner.

(6) *Deemed satisfaction of obligation.* For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. See paragraphs (j) and (k) of this section.

(c) *Partner or related person as lender—*

(1) *In general.* A partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.

(2) *Wrapped debt.* If a partnership liability is owed to a partner or related person and that liability includes (*i.e.*, is “wrapped” around) a nonrecourse obligation encumbering partnership property that is owed to another person, the partnership liability will be treated as two separate liabilities. The portion of the partnership liability corresponding to the wrapped debt is treated as a liability owed to another person.

(d) *De minimis exceptions—*(1) *Partner as lender.* The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed).

(2) *Partner as guarantor.* The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or

more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.

(e) *Special rule for nonrecourse liability with interest guaranteed by a partner—*(1)

In general. For purposes of this section, if one or more partners or related persons have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities. If this rule applies, the partner or related person that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a nonrecourse liability. Generally, in applying this rule, it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if, upon a default in payment by the partnership, the lender can enforce the interest guaranty without foreclosing on the property and thereby extinguishing the underlying debt. The guarantee of interest rule continues to apply even after the point at which the amount of guaranteed interest that will accrue is less than 25 percent of the total interest that will accrue on the liability.

(2) *Computation of present value.* The present value of the guaranteed future interest payments is computed using a discount rate equal to either the interest rate stated in the loan documents, or if interest is imputed under either

section 483 or section 1274, the applicable federal rate, compounded semi-annually. The computation takes into account any payment of interest that the partner or related person may be required to make only to the extent that the interest will accrue economically (determined in accordance with section 446 and the regulations thereunder) after the date of the interest guarantee. If the loan document contains a variable rate of interest that is an interest rate based on current values of an objective interest index, the present value is computed on the assumption that the interest determined under the objective interest index on the date of the computation will remain constant over the term of the loan. The term “objective interest index” has the meaning given to it in section 1275 and the regulations thereunder (relating to variable rate debt instruments). Examples of an objective interest index include the prime rate of a designated financial institution, LIBOR (London Interbank Offered Rate), and the applicable federal rate under section 1274(d).

(3) *Safe harbor.* The general rule contained in paragraph (e)(1) of this section does not apply to a partnership nonrecourse liability if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability.

(4) *De minimis exception.* The general rule contained in paragraph (e)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees the interest on a loan to that partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). An allocation of interest to the extent paid by the guarantor is not treated as a partnership item of deduction or loss subject to the 10 percent or less rule.

(f) *Examples.* The following examples illustrate the principles of paragraphs (a) through (e) of this section.

Example 1. Determining when a partner bears the economic risk of loss. A and B form a general partnership with each contributing \$100 in cash. The partnership purchases an office building on leased land for \$1,000 from an unrelated seller, paying \$200 in cash and executing a note to the seller for the balance of \$800. The note is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. The partnership agreement provides that all items are allocated equally except that tax losses are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under section 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the \$800 liability becomes due and payable. All of the partnership’s assets, including the building, are deemed to be worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	\$100	\$100
Loss on hypothetical sale	(900)	(100)
	(\$800)	\$0

Other than the partners’ obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, \$800 of the partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for non-payment. B has no share of the \$800 liability since the constructive liquidation produces no payment obligation for B. A’s share of the partnership liability is \$800 because A would have an obligation in that amount to make a contribution to the partnership.

Example 2. Recourse liability; deficit restoration obligation. C and D each contribute \$500 in cash to the capital of a new general partnership, CD. CD purchases property from an unrelated seller for \$1,000 in cash and a \$9,000 mortgage note. The note is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. The partnership agreement provides that profits and losses are to be divided 40% to C and 60% to D. C and D are required to make up any deficit in their capital accounts. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of

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all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	C	D
Initial contribution	\$500	\$500
Loss on hypothetical sale	(4,000) (\$3,500)	(6,000) (\$5,500)

C's capital account reflects a deficit that C would have to make up to \$3,500 and D's capital account reflects a deficit that D would have to make up of \$5,500. Therefore, the \$9,000 mortgage note is a recourse liability because one or more partners bear the economic risk of loss for the liability. C's share of the recourse liability is \$3,500 and D's share is \$5,500.

Example 3. Guarantee by limited partner; partner deemed to satisfy obligation. E and F form a limited partnership. E, the general partner, contributes \$2,000 and F, the limited partner, contributes \$8,000 in cash to the partnership. The partnership agreement allocates losses 20% to E and 80% to F until F's capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for \$25,000 using its \$10,000 cash and a \$15,000 recourse loan from a bank. F guarantees payment of the \$15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. In a constructive liquidation, the \$15,000 liability becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	E	F
Initial contribution	\$2,000	\$8,000
Loss on hypothetical sale	(17,000) (\$15,000)	(8,000) \$0

E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of \$15,000. Because E is assumed to satisfy that obligation, it is also assumed that F would not have to satisfy F's guarantee. The \$15,000 mortgage is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is \$15,000, and F's share is zero. This would be so even if E's net worth at the time of the determination is less than \$15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership.

Example 4. Partner guarantee with right of subrogation. G, a limited partner in the GH partnership, guarantees a portion of a partnership liability. The liability is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. If under state law G is subrogated to the rights of the lender, G would have the right to recover the amount G paid to the recourse lender from the general partner. Therefore, G does not bear the economic risk of loss for the partnership liability.

Example 5. Bifurcation of partnership liability; guarantee of part of nonrecourse liability. A partnership borrows \$10,000, secured by a mortgage on real property. The mortgage note contains an exoneration clause which provides that in the event of default, the holder's only remedy is to foreclose on the property. The holder may not look to any other partnership asset or to any partner to pay the liability. However, to induce the lender to make the loan, a partner guarantees payment of \$200 of the loan principal. The exoneration clause does not apply to the partner's guarantee. If the partner paid pursuant to the guarantee, the partner would be subrogated to the rights of the lender with respect to \$200 of the mortgage debt, but the partner is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, \$200 of the \$10,000 mortgage liability is treated as a recourse liability of the partnership and \$9,800 is treated as a nonrecourse liability of the partnership. The partner's share of the recourse liability of the partnership is \$200.

Example 6. Wrapped debt. I, an individual, purchases real estate from an unrelated seller for \$10,000, paying \$1,000 in cash and giving a \$9,000 purchase mortgage note on which I has no personal liability and as to which the seller can look only to the property for satisfaction. At a time when the property is worth \$15,000, I sells the property to a partnership in which I is a general partner. The partnership pays for the property with a partnership purchase money mortgage note of \$15,000 on which neither the partnership nor any partner (or person related to a partner) has personal liability. The \$15,000 mortgage note is a wrapped debt that includes the \$9,000 obligation to the original seller. The liability is a recourse liability to the extent of \$6,000 because I is the creditor with respect to the loan and I bears the economic risk of loss for \$6,000. I's share of the recourse liability is \$6,000. The remaining \$9,000 is treated as a partnership nonrecourse liability that is owed to the unrelated seller.

Example 7. Guarantee of interest by partner treated as part recourse and part nonrecourse. On January 1, 1992, a partnership obtains a \$4,000,000 loan secured by a shopping center

owned by the partnership. Neither the partnership nor any partner has any personal liability under the loan documents for repayment of the stated principal amount. Interest accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal is payable in a lump sum on December 31, 2006. A partner guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the loan, the present value (discounted at 15 percent, compounded annually) of the future interest payments is \$3,508,422, and of the future principal payment is \$491,578. If tested on that date, the loan would be treated as a partnership liability of \$1,754,211 (\$3,508,422 \times .5) for which the guaranteeing partner bears the economic risk of loss and a partnership nonrecourse liability of \$2,245,789 (\$1,754,211 + \$491,578).

Example 8. Contingent obligation not recognized. J and K form a general partnership with cash contributions of \$2,500 each. J and K share partnership profits and losses equally. The partnership purchases an apartment building for its \$5,000 of cash and a \$20,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the building. The loan documents provide that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in the value of the apartment building resulting from the partnership's failure properly to maintain the property. There are no facts that establish with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership's failure properly to maintain the building. Therefore, no partner bears the economic risk of loss, and the liability constitutes a nonrecourse liability. Under § 1.752-3, J and K share this nonrecourse liability equally because they share all profits and losses equally.

(g) *Time-value-of-money considerations*—(1) *In general.* The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in the time when a payment or contribution obligation with respect to a partnership liability is to be satisfied. If a payment obligation with respect to a partnership liability is not required to be satisfied within a reasonable time after the liability becomes due and payable, or if the obligation to make a contribution to the partnership is not required to be satisfied before the later of—

- (i) The end of the year in which the partner's interest is liquidated, or
- (ii) 90 days after the liquidation,

the obligation is recognized only to the extent of the value of the obligation.

(2) *Valuation of an obligation.* The value of a payment or contribution obligation that is not required to be satisfied within the time period specified in paragraph (g)(1) of this section equals the entire principal balance of the obligation only if the obligation bears interest equal to or greater than the applicable federal rate under section 1274(d) at the time of valuation, commencing on—

(i) In the case of a payment obligation, the date that the partnership liability to a creditor or other person to whom the obligation relates becomes due and payable, or

(ii) In the case of a contribution obligation, the date of the liquidation of the partner's interest in the partnership. If the obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is discounted to the present value of all payments due from the partner or related person (*i.e.*, the imputed principal amount computed under section 1274(b)). For purposes of making this present value determination, the partnership is deemed to have constructively liquidated as of the date on which the payment obligation is valued and the payment obligation is assumed to be a debt instrument subject to the rules of section 1274 (*i.e.*, the debt instrument is treated as if it were issued for property at the time of the valuation).

(3) *Satisfaction of obligation with partner's promissory note.* An obligation is not satisfied by the transfer to the obligee of a promissory note by a partner or related person unless the note is readily tradeable on an established securities market.

(4) *Example.* The following example illustrates the principle of paragraph (g) of this section.

Example. Value of obligation not required to be satisfied within specified time period. A, the general partner, and B, the limited partner, each contributes \$10,000 to partnership AB. AB purchases property from an unrelated seller for \$20,000 in cash and a \$70,000

recourse purchase money note. The partnership agreement provides that profits and losses are to be divided equally. A and B are required to make up any deficit in their capital accounts. While A is required to restore any deficit balance in A's capital account within 90 days after the date of liquidation of the partnership, B is not required to restore any deficit for two years following the date of liquidation. The deficit in B's capital account will not bear interest during that two-year period. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	\$10,000	\$10,000
Loss on hypothetical sale	(45,000)	(45,000)
	(35,000)	(35,000)

A's and B's capital accounts each reflect deficits of \$35,000. B's obligation to make a contribution pursuant to B's deficit restoration obligation is recognized only to the extent of the fair market value of that obligation at the time of the constructive liquidation because B is not required to satisfy that obligation by the later of the end of the partnership taxable year in which B's interest is liquidated or within 90 days after the date of the liquidation. Because B's obligation does not bear interest, the fair market value is deemed to equal the imputed principal amount under section 1274(b). Under section 1274(b), the imputed principal amount of a debt instrument equals the present value of all payments due under the debt instrument. Assume the applicable federal rate with respect to B's obligation is 10 percent compounded semiannually. Using this discount rate, the present value of the \$35,000 payment that B would be required to make two years after the constructive liquidation to restore the deficit balance in B's capital account equals \$28,795. To the extent that B's deficit restoration obligation is not recognized, it is assumed that B's obligation does not exist. Therefore, A, as the sole general partner, would be obligated by operation of law to contribute an additional \$6,205 of capital to the partnership. Accordingly, under paragraph (g) of this section, B bears the economic risk of loss for \$28,795 and A bears the economic risk of loss for \$41,205 (\$35,000 + \$6,205).

(h) *Partner providing property as security for partnership liability*—(1) *Direct pledge*. A partner is considered to bear

the economic risk of loss for a partnership liability to the extent of the value of any the partner's or related person's separate property (other than a direct or indirect interest in the partnership) that is pledged as security for the partnership liability.

(2) *Indirect pledge*. A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any property that the partner contributes to the partnership solely for the purpose of securing a partnership liability. Contributed property is not treated as contributed solely for the purpose of securing a partnership liability unless substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.

(3) *Valuation*. The extent to which a partner bears the economic risk of loss for a partnership liability as a result of a direct pledge described in paragraph (h)(1) of this section or an indirect pledge described in paragraph (h)(2) of this section is limited to the net fair market value of the property (pledged property) at the time of the pledge or contribution. If a partner provides additional pledged property, the addition is treated as a new pledge and the net fair market value of the pledged property (including but not limited to the additional property) must be determined at that time. For purposes of this paragraph (h), if pledged property is subject to one or more other obligations, those obligations must be taken into account in determining the net fair market value of pledged property at the time of the pledge or contribution.

(4) *Partner's promissory note*. For purposes of paragraph (h)(2) of this section, a promissory note of the partner or related person that is contributed to the partnership shall not be taken into account unless the note is readily tradeable on an established securities market.

(i) *Treatment of recourse liabilities in tiered partnerships*. If a partnership (the

“upper-tier partnership”) owns (directly or indirectly through one or more partnerships) an interest in another partnership (the “lower-tier partnership”), the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following—

(1) The amount of the economic risk of loss that the upper-tier partnership bears with respect to the liabilities; and

(2) Any other amount of the liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss.

(j) *Anti-abuse rules*—(1) *In general*. An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

(2) *Arrangements tantamount to a guarantee*. Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that:

(i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;

(ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(iii) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

The partners are considered to bear the economic risk of loss for the liability

in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership which is not on commercially reasonable terms may be tantamount to a guarantee by the partner of a partnership liability.

(3) *Plan to circumvent or avoid the obligation*. An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

(4) *Example*. The following example illustrates the principle of paragraph (j)(3) of this section.

Example. Plan to circumvent or avoid obligation. A and B form a general partnership. A, a corporation, contributes \$20,000 and B contributes \$80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B’s capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for \$250,000 using its \$100,000 cash and a \$150,000 recourse loan from a bank. B guarantees payment of the \$150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary, formed by a parent of a consolidated group, with capital limited to \$20,000 to allow the consolidated group to enjoy the tax losses generated by the property while at the same time limiting its monetary exposure for such losses. These facts, when considered together with B’s guarantee, indicate a plan to circumvent or avoid A’s obligation to contribute to the partnership. The rules of section 752 must be applied as if A’s obligation to contribute did not exist. Accordingly, the \$150,000 liability is a recourse liability that is allocated entirely to B.

(k) *Effect of a disregarded entity*—(1) *In general*. In determining the extent to which a partner bears the economic risk of loss for a partnership liability, an obligation under paragraph (b)(1) of this section (§1.752-2(b)(1) payment obligation) of a business entity that is disregarded as an entity separate from its owner under sections 856(i) or 1361(b)(3) or §§301.7701-1 through 301.7701-3 of this chapter (disregarded entity) is taken into account only to the extent of the net value of the disregarded entity as of the allocation date (as defined in paragraph (k)(2)(iv) of this section) that is allocated to the

partnership liability as determined under the rules of this paragraph (k). The rules of this paragraph (k) do not apply to a §1.752-2(b)(1) payment obligation of a disregarded entity to the extent that the owner of the disregarded entity is otherwise required to make a payment (that satisfies the requirements of paragraph (b)(1) of this section) with respect to the obligation of the disregarded entity.

(2) *Net value of a disregarded entity*—(i) *Definition.* For purposes of this paragraph (k), the net value of a disregarded entity equals the following—

(A) The fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law (including the disregarded entity's enforceable rights to contributions from its owner and the fair market value of an interest in any partnership other than the partnership for which net value is being determined, but excluding the disregarded entity's interest in the partnership for which the net value is being determined and the net fair market value of property pledged to secure a liability of the partnership under paragraph (h)(1) of this section); less

(B) All obligations of the disregarded entity that do not constitute §1.752-2(b)(1) payment obligations of the disregarded entity.

(ii) *Timing of the net value determination*—(A) *Initial determination.* If a partnership interest is held by a disregarded entity, and the partnership has or incurs a liability, all or a portion of which may be allocable to the owner of the disregarded entity under this paragraph (k), the disregarded entity's net value must be initially determined on the allocation date described in paragraph (k)(2)(iv) of this section.

(B) *Other events.* If a partnership interest is held by a disregarded entity, and the partnership has or incurs a liability, all or a portion of which may be allocable to the owner of the disregarded entity under this paragraph (k), then, if one or more valuation events (as defined in paragraph (k)(2)(iii) of this section) occur during the partnership taxable year, except as provided in paragraph (k)(2)(iii)(E) of this section, the net value of the disregarded entity is determined on the

allocation date described in paragraph (k)(2)(iv) of this section.

(iii) *Valuation events.* The following are valuation events for purposes of this paragraph (k):

(A) A more than de minimis contribution to a disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section, unless the contribution is followed immediately by a contribution of equal net value by the disregarded entity to the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such contributions.

(B) A more than de minimis distribution from a disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section, unless the distribution immediately follows a distribution of equal net value to the disregarded entity by the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such distributions.

(C) A change in the legally enforceable obligation of the owner of the disregarded entity to make contributions to the disregarded entity.

(D) The incurrence, refinancing, or assumption of an obligation of the disregarded entity that does not constitute a §1.752-2(b)(1) payment obligation of the disregarded entity.

(E) The sale or exchange of a non-de minimis asset of the disregarded entity (in a transaction that is not in the ordinary course of business). In this case, the net value of the disregarded entity may be adjusted only to reflect the difference, if any, between the fair market value of the asset at the time of the sale or exchange and the fair market value of the asset when the net value of the disregarded entity was last determined. The adjusted net value is taken into account for purposes of §1.752-2(k)(1) as of the allocation date.

(iv) *Allocation Date.* For purposes of this paragraph (k), the allocation date is the earlier of—

(A) The first date occurring on or after the date on which the requirement to determine the net value of a disregarded entity arises under paragraph (k)(2)(ii)(A) or (B) of this section on which the partnership otherwise determines a partner's share of partnership liabilities under §§1.705-1(a) and 1.752-4(d); or

(B) The end of the partnership's taxable year in which the requirement to determine the net value of a disregarded entity arises under paragraph (k)(2)(ii)(A) or (B) of this section.

(3) *Multiple liabilities.* If one or more disregarded entities have §1.752-2(b)(1) payment obligations with respect to one or more liabilities of a partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account the relative priorities of those liabilities.

(4) *Reduction in net value of a disregarded entity.* For purposes of this paragraph (k), the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the disregarded entity if, at the time the net value of the disregarded entity is determined, it is anticipated that the net value of the disregarded entity will subsequently be reduced and the reduction is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability.

(5) *Information to be provided by the owner of a disregarded entity.* A partner that may be treated as bearing the economic risk of loss for a partnership liability based upon a §1.752-2(b)(1) payment obligation of a disregarded entity must provide information to the partnership as to the entity's tax classification and the net value of the disregarded entity that is appropriately allocable to the partnership's liabilities on a timely basis.

(6) *Examples.* The following examples illustrate the rules of this paragraph (k):

Example 1. Disregarded entity with net value of zero. (i) In 2007, A forms a wholly owned domestic limited liability company, LLC, with a contribution of \$100,000. A has no liability for LLC's debts, and LLC has no en-

forceable right to contribution from A. Under §301.7701-3(b)(1)(ii) of this chapter, LLC is a disregarded entity. Also in 2007, LLC contributes \$100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes \$100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to make up any deficit in its capital account. On January 1, 2008, LP borrows \$300,000 from a bank and uses \$600,000 to purchase nondepreciable property. The \$300,000 debt is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its \$300,000 debt during 2008. LP has a net taxable loss in 2008, and under §§1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the \$300,000 debt at the end of its taxable year, December 31, 2008. As of that date, LLC holds no assets other than its interest in LP.

(ii) Because LLC is a disregarded entity, A is treated as the partner in LP for Federal tax purposes. Only LLC has an obligation to make a payment on account of the \$300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under this paragraph (k), A is treated as bearing the economic risk of loss for LP's \$300,000 debt only to the extent of LLC's net value. Because that net value is \$0 on December 31, 2008, when LP determines its partners' shares of its \$300,000 debt, A is not treated as bearing the economic risk of loss for any portion of LP's \$300,000 debt. As a result, LP's \$300,000 debt is characterized as nonrecourse under §1.752-1(a) and is allocated as required by §1.752-3.

Example 2. Disregarded entity with positive net value. (i) The facts are the same as in *Example 1* except that on January 1, 2009, A contributes \$250,000 to LLC. On January 5, 2009, LLC borrows \$100,000 and LLC shortly thereafter uses the \$350,000 to purchase unimproved land. LP makes payments of only interest on its \$300,000 debt during 2009. As of December 31, 2009, LLC holds its interest in LP and the land, the value of which has declined to \$275,000. LP has a net taxable loss in 2009, and under §§1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the \$300,000 debt at the end of its taxable year, December 31, 2009.

(ii) A's contribution of \$250,000 to LLC on January 1, 2009, constitutes a more than de minimis contribution of property to LLC under paragraph (k)(2)(iii)(A) of this section and the debt incurred by LLC on January 5, 2009, is a valuation event under paragraph (k)(2)(iii)(D) of this section. Accordingly, under paragraph (k)(2)(ii) of this section, LLC's value must be redetermined as of the end of the partnership's taxable year. At that time LLC's net value is \$175,000 (\$275,000 land—\$100,000 debt). Accordingly, \$175,000 of

LP's \$300,000 debt will be recharacterized as recourse under § 1.752-1(a) and allocated to A under this section, and the remaining \$125,000 of LP's \$300,000 debt will remain characterized as nonrecourse under § 1.752-1(a) and is allocated as required by § 1.752-3.

Example 3. Multiple partnership liabilities. (i) The facts are the same as in *Example 2* except that on January 1, 2010, A forms another wholly owned domestic limited liability company, LLC2, with a contribution of \$120,000. Shortly thereafter, LLC2 uses the \$120,000 to purchase stock in X corporation. A has no liability for LLC2's debts, and LLC2 has no enforceable right to contribution from A. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC2 is a disregarded entity. On July 1, 2010, LP borrows \$100,000 from a bank and uses the \$100,000 to purchase nondepreciable property. The \$100,000 debt is secured by the property and is also a general obligation of LP. The \$100,000 debt is senior in priority to LP's existing \$300,000 debt. Also, on July 1, 2010, LLC2 agrees to guarantee both LP's \$100,000 and \$300,000 debts. LP makes payments of only interest on both its \$100,000 and \$300,000 debts during 2010. LP has a net taxable loss in 2010 and, under §§ 1.705-1(a) and 1.752-4(d), must determine its partners' shares of its \$100,000 and \$300,000 debts at the end of its taxable year, December 31, 2010. As of that date, LLC holds its interest in LP and the land, and LLC2 holds the X corporation stock which has appreciated in value to \$140,000.

(ii) Both LLC and LLC2 have obligations to make a payment on account of LP's debts if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under paragraph (k)(1) of this section, A is treated as bearing the economic risk of loss for LP's \$100,000 and \$300,000 debts only to the extent of the net values of LLC and LLC2, as allocated among those debts in a reasonable and consistent manner pursuant to paragraph (k)(3) of this section.

(iii) No events have occurred that would allow a valuation of LLC under paragraph (k)(2)(iii) of this section. Therefore, LLC's net value remains \$175,000. LLC2's net value as of December 31, 2010, when LP determines its partners' shares of its liabilities, is \$140,000. Under paragraph (k)(3) of this section, LP must allocate the net values of LLC and LLC2 between its \$100,000 and \$300,000 debts in a reasonable and consistent manner. Because the \$100,000 debt is senior in priority to the \$300,000 debt, LP first allocates the net values of LLC and LLC2, pro rata, to its \$100,000 debt. Thus, LP allocates \$56,000 of LLC's net value and \$44,000 of LLC2's net value to its \$100,000 debt, and A is treated as bearing the economic risk of loss for all of LP's \$100,000 debt. As a result, all of LP's \$100,000 debt is characterized as recourse under § 1.752-1(a) and is allocated to A under this section. LP then allocates the remain-

ing \$119,000 of LLC's net value and LLC2's \$96,000 net value to its \$300,000 debt, and A is treated as bearing the economic risk of loss for a total of \$215,000 of the \$300,000 debt. As a result, \$215,000 of LP's \$300,000 debt is characterized as recourse under § 1.752-1(a) and is allocated to A under this section, and the remaining \$85,000 of LP's \$300,000 debt is characterized as nonrecourse under § 1.752-1(a) and is allocated as required by § 1.752-3. This example illustrates one reasonable method of allocating net values of disregarded entities among multiple partnership liabilities.

Example 4. Disregarded entity with interests in two partnerships. (i) In 2007, B forms a wholly owned domestic limited liability company, LLC, with a contribution of \$175,000. B has no liability for LLC's debts and LLC has no enforceable right to contribution from B. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC is a disregarded entity. LLC contributes \$50,000 to LP1 in exchange for a general partnership interest in LP1, and \$25,000 to LP2 in exchange for a general partnership interest in LP2. LLC retains the \$100,000 in cash. Both LP1 and LP2 have taxable years that end on December 31 and, under both LP1's and LP2's partnership agreements, only LLC is required to make up any deficit in its capital account. During 2007, LP1 and LP2 incur partnership liabilities that are general obligations of the partnership. LP1 borrows \$300,000 (Debt 1), and LP2 borrows \$60,000 (Debt 2) and \$40,000 (Debt 3). Debt 2 is senior in priority to Debt 3. LP1 and LP2 make payments of only interest on Debts 1, 2, and 3 during 2007. As of the end of taxable year 2007, LP1 and LP2 each have a net taxable loss and must determine its partners' shares of partnership liabilities under §§ 1.705-1(a) and 1.752-4(d) as of December 31, 2007. As of that date, LLC's interest in LP1 has a fair market value of \$45,000, and LLC's interest in LP2 has a fair market value of \$15,000.

(ii) Because LLC is a disregarded entity, B is treated as the partner in LP1 and LP2 for federal tax purposes. Only LLC has an obligation to make a payment on account of Debts 1, 2, and 3 if LP1 and LP2 were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under this paragraph (k), B is treated as bearing the economic risk of loss for LP1's and LP2's liabilities only to the extent of LLC's net value as of the allocation date, December 31, 2007.

(iii) LLC's net value with respect to LP1 is \$115,000 (\$100,000 cash + \$15,000 interest in LP2). Therefore, under paragraph (k)(1) of this section, B is treated as bearing the economic risk of loss for \$115,000 of Debt 1. Accordingly, \$115,000 of LP1's \$300,000 debt is characterized as recourse under § 1.752-1(a) and is allocated to B under this section. The balance of Debt 1 (\$185,000) is characterized

as nonrecourse under § 1.752-1(a) and is allocated as required by § 1.752-3.

(iv) LLC's net value with respect to LP2 is \$145,000 (\$100,000 cash + \$45,000 interest in LP1). Therefore, under paragraph (k)(1) of this section, B is treated as bearing the economic risk of loss with respect to Debts 2 and 3 only to the extent of \$145,000. Because Debt 2 is senior in priority to Debt 3, LP2 first allocates \$60,000 of LLC's net value to Debt 2. LP2 then allocates \$40,000 of LLC's net value to Debt 3. As a result, both Debts 2 and 3 are characterized as recourse under § 1.752-1(a) and allocated to B. This example illustrates one reasonable method of allocating the net value of a disregarded entity among multiple partnership liabilities.

(l) *Effective dates.* Paragraph (a), the last sentence of paragraph (b)(6), and paragraphs (h)(3) and (k) of this section apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. The rules applicable to liabilities incurred or assumed (or subject to a binding contract in effect) prior to October 11, 2006 are contained in § 1.752-2 in effect prior to October 11, 2006, (see 26 CFR part 1 revised as of April 1, 2006).

[T.D. 8380, 56 FR 66351, Dec. 23, 1991; 57 FR 4913, Feb. 10, 1992; 57 FR 5054, Feb. 12, 1992; 57 FR 5511, Feb. 14, 1992; T.D. 9289, 71 FR 59672, Oct. 11, 2006]

§ 1.752-3 Partner's share of nonrecourse liabilities.

(a) *In general.* A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows—

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allo-

cated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of § 1.707-5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

(b) *Allocation of a single nonrecourse liability among multiple properties—*(1) *In general.* For purposes of determining the amount of taxable gain under paragraph (a)(2) of this section, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability

among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

(2) *Reductions in principal.* For purposes of this paragraph (b), when the outstanding principal of a partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under paragraph (b)(1) of this section.

(c) *Examples.* The following examples illustrate the principles of this section:

Example 1. Partner's share of nonrecourse liabilities. The AB partnership purchases depreciable property for a \$1,000 purchase money note that is nonrecourse liability under the rules of this section. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement provides that all items of income, gain, loss, and deduction are allocated equally. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they have equal interests in partnership profits. A and B are each treated as if they contributed \$500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from \$0 to \$500). The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of

gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims a depreciation deduction of \$200 for the depreciable property for the year it acquires that property, partnership minimum gain for the year will increase by \$200 (the excess of the \$1,000 nonrecourse liability over the \$800 adjusted tax basis of the property). See section 704(b) and the regulations thereunder. A and B each have a \$100 share of partnership minimum gain at the end of that year because the depreciation deduction is treated as a nonrecourse deduction. See section 704(b) and the regulation thereunder. Accordingly, at the end of that year, A and B are allocated \$100 each of the nonrecourse liability to match their shares of partnership minimum gain. The remaining \$800 of the nonrecourse liability will be allocated equally between A and B (\$400 each).

Example 2. Excess nonrecourse liabilities allocated consistently with reasonably expected deductions. The facts are the same as in *Example 1* except that the partnership agreement provides that depreciation deductions will be allocated to A. The partners agree to allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Assuming that the allocation of all of the depreciation deductions to A is valid under section 704(b), immediately after purchasing the depreciable property, A's share of the nonrecourse liability is \$1,000. Accordingly, A is treated as if A contributed \$1,000 to the partnership.

Example 3. Allocation of liability among multiple properties. (i) A and B are equal partners in a partnership (PRS). A contributes \$70 of cash in exchange for a 50-percent interest in PRS. B contributes two items of property, X and Y, in exchange for a 50-percent interest in PRS. Property X has a fair market value (and book value) of \$70 and an adjusted basis of \$40, and is subject to a nonrecourse liability of \$50. Property Y has a fair market value (and book value) of \$120, an adjusted basis of \$40, and is subject to a nonrecourse liability of \$70. Immediately after the initial contributions, PRS refinances the two separate liabilities with a single \$120 nonrecourse liability. All of the built-in gain attributable to Property X (\$30) and Property Y (\$80) is section 704(c) gain allocable to B.

(ii) The amount of the nonrecourse liability (\$120) is less than the total book value of all of the properties that are subject to such liability (\$70 + \$120 = \$190), so there is no partnership minimum gain. § 1.704-2(d). Accordingly, no portion of the liability is allocated pursuant to paragraph (a)(1) of this section.

(iii) Pursuant to paragraph (b)(1) of this section, PRS decides to allocate the nonrecourse liability evenly between the Properties X and Y. Accordingly, each of Properties X and Y are treated as being subject to a separate \$60 nonrecourse liability for purposes of applying paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B will be allocated \$20 of the liability for each of Properties X and Y (in each case, \$60 liability minus \$40 adjusted basis). As a result, a portion of the liability is allocated pursuant to paragraph (a)(2) of this section as follows:

Partner	Property	Tier 1	Tier 2
A	X	\$0	\$0
	Y	0	0
B	X	0	20
	Y	0	20

(iv) PRS has \$80 of excess nonrecourse liability that it may allocate in any manner consistent with paragraph (a)(3) of this section. PRS determines to allocate the \$80 of excess nonrecourse liabilities to the partners up to their share of the remaining section 704(c) gain on the properties, with any remaining amount of liabilities being allocated equally to A and B consistent with their equal interests in partnership profits. B has \$70 of remaining section 704(c) gain (\$10 on Property X and \$60 on Property Y), and thus will be allocated \$70 of the liability in accordance with this gain.

The remaining \$10 is divided equally between A and B. Accordingly, the overall allocation of the \$120 nonrecourse liability is as follows:

Partner	Tier 1	Tier 2	Tier 3	Total
A	\$0	\$0	\$5	\$5
B	0	40	75	115

[T.D. 8380, 56 FR 66355, Dec. 23, 1991, as amended by T.D. 8906, 65 FR 64890, Oct. 31, 2000]

§ 1.752-4 Special rules.

(a) *Tiered partnerships.* An upper-tier partnership's share of the liabilities of a lower-tier partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

(b) *Related person definition—(1) In general.* A person is related to a partner if the person and the partner bear a relationship to each other that is speci-

fied in section 267(b) or 707(b)(1), subject to the following modifications:

(i) Substitute "80 percent or more" for "more than 50 percent" each place it appears in those sections;

(ii) A person's family is determined by excluding brothers and sisters; and

(iii) Disregard sections 267(e)(1) and 267(f)(1)(A).

(2) *Person related to more than one partner—(i) In general.* If, in applying the related person rules in paragraph (b)(1) of this section, a person is related to more than one partner, paragraph (b)(1) of this section is applied by treating the person as related only to the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated equally among the partners having the equal percentages of related ownership.

(ii) *Natural persons.* For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other.

(iii) *Related partner exception.* Notwithstanding paragraph (b)(1) of this section (which defines related person), persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership. This paragraph (iii) does not apply when determining a partner's interest under the de minimis rules in §§ 1.752-2 (d) and (e).

(iv) *Special rule where entity structured to avoid related person status—(A) In general.* If—

(1) A partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust;

(2) A partner or related person owns (directly or indirectly) a 20 percent or more ownership interest in the other entity; and

(3) A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner that

owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability; then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity.

(B) *Ownership interest.* For purposes of paragraph (b)(2)(iv)(A) of this section, a person's ownership interest in:

(1) A partnership equals the partner's highest percentage interest in any item of partnership loss or deduction for any taxable year;

(2) An S corporation equals the percentage of the outstanding stock in the S corporation owned by the shareholder;

(3) A C corporation equals the percentage of the fair market value of the issued and outstanding stock owned by the shareholder; and

(4) A trust equals the percentage of the actuarial interests owned by the beneficial owner of the trust.

(C) *Example.* Entity structured to avoid related person status. A, B, and C form a general partnership, ABC. A, B, and C are equal partners, each contributing \$1,000 to the partnership. A and B want to loan money to ABC and have the loan treated as nonrecourse for purposes of section 752. A and B form partnership AB to which each contributes \$50,000. A and B share losses equally in partnership AB. Partnership AB loans partnership ABC \$100,000 on a nonrecourse basis secured by the property ABC buys with the loan. Under these facts and circumstances, A and B bear the economic risk of loss with respect to the partnership liability equally based on their percentage interest in losses of partnership AB.

(c) *Limitation.* The amount of an indebtedness is taken into account only once, even though a partner (in addition to the partner's liability for the indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

(d) *Time of determination.* A partner's share of partnership liabilities must be determined whenever the determination is necessary in order to determine the tax liability of the partner or any other person. See § 1.705-1(a) for rules regarding when the adjusted basis of a

partner's interest in the partnership must be determined.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991]

§ 1.752-5 Effective dates and transition rules.

(a) *In general.* Except as otherwise provided in §§ 1.752-1 through 1.752-4, unless a partnership makes an election under paragraph (b)(1) of this section to apply the provisions of §§ 1.752-1 through 1.752-4 earlier, §§ 1.752-1 through 1.752-4 apply to any liability incurred or assumed by a partnership on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. However, § 1.752-3(a)(3) fifth, sixth, and seventh sentences, (b), and (c) *Example 3*, do not apply to any liability incurred or assumed by a partnership prior to October 31, 2000. Nevertheless, § 1.752-3(a)(3) fifth, sixth, and seventh sentences, (b), and (c) *Example 3*, may be relied upon for any liability incurred or assumed by a partnership prior to October 31, 2000 for taxable years ending on or after October 31, 2000. In addition, § 1.752-1(f) last sentence and (g) *Example 2*, do not apply to any liability incurred or assumed by a partnership prior to January 4, 2001. Nevertheless, § 1.752-1(f) last sentence and (g) *Example 2*, may be relied on for any liability incurred or assumed by a partnership prior to January 4, 2001 and, unless the partnership makes an election under paragraph (b)(1) of this section, on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. For liabilities incurred or assumed by a partnership prior to December 28, 1991 (or pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter), unless an election to apply these regulations has been made, see §§ 1.752-0T to 1.752-4T, set forth in 26 CFR 1.752-0T through 1.752-4T as contained in 26 CFR edition revised April 1, 1991, (TD 8237, TD 8274, and TD 8355) and § 1.752-1, set forth in 26 CFR 1.752-

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1 as contained in 26 CFR edition revised April 1, 1988 (TD 6175 and TD 6500).

(b) *Election*—(1) *In general.* A partnership may elect to apply the provisions of §§ 1.752-1 through 1.752-4 to all of its liabilities to which the provisions of those sections do not otherwise apply as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991.

(2) *Time and manner of election.* An election under this paragraph (b) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and contain a declaration that an election is being made under this paragraph (b).

(c) *Effect of section 708(b)(1)(B) termination on determining date liabilities are incurred or assumed.* For purposes of applying this section, a termination of the partnership under section 708(b)(1)(B) will not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of the termination.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991, as amended by T.D. 8906, 65 FR 64890, Oct. 31, 2000; T.D. 8925, 66 FR 723, Jan. 4, 2001; T.D. 9207, 70 FR 30343, May 26, 2005]

§ 1.752-6 Partnership assumption of partner's section 358(h)(3) liability after October 18, 1999, and before June 24, 2003.

(a) *In general.* If, in a transaction described in section 721(a), a partnership assumes a liability (defined in section 358(h)(3)) of a partner (other than a liability to which section 752(a) and (b) apply), then, after application of section 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. For purposes of this section, the adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under §§ 1.752-1 through 1.752-5.

(b) *Exceptions*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, the exceptions contained in section 358(h)(2)(A) and (B) apply to this section.

(2) *Transactions described in Notice 2000-44.* The exception contained in section 358(h)(2)(B) does not apply to an assumption of a liability (defined in section 358(h)(3)) by a partnership as part of a transaction described in, or a transaction that is substantially similar to the transactions described in, Notice 2000-44 (2000-2 C.B. 255). See § 601.601(d)(2) of this chapter.

(c) *Example.* The following example illustrates the principles of paragraph (a) of this section:

Example. In 1999, A and B form partnership PRS. A contributes property with a value and basis of \$200, subject to a nonrecourse debt obligation of \$50 and a fixed or contingent obligation of \$100 that is not a liability to which section 752(a) and (b) applies, in exchange for a 50% interest in PRS. Assume that, after the contribution, A's share of partnership liabilities under §§ 1.752-1 through 1.752-5 is \$25. Also assume that the \$100 liability is not associated with a trade or business contributed by A to PRS or with assets contributed by A to PRS. After the contribution, A's basis in PRS is \$175 (A's basis in the contributed land (\$200) reduced by the nonrecourse debt assumed by PRS (\$50), increased by A's share of partnership liabilities under §§ 1.752-1 through 1.752-5 (\$25)). Because A's basis in the PRS interest is greater than the adjusted value of A's interest, \$75 (the fair market value of A's interest (\$50) increased by A's share of partnership liabilities (\$25)), paragraph (a) of this section operates to reduce A's basis in the PRS interest (but not below the adjusted value of that interest) by the amount of liabilities described in section 358(h)(3) (other than liabilities to which section 752(a) and (b) apply) assumed by PRS. Therefore, A's basis in PRS is reduced to \$75.

(d) *Effective date*—(1) *In general.* This section applies to assumptions of liabilities occurring after October 18, 1999, and before June 24, 2003.

(2) *Election to apply § 1.752-7.* The partnership may elect, under § 1.752-7(k)(2), to apply the provisions referenced in § 1.752-7(k)(2)(ii) to all assumptions of liabilities by the partnership occurring after October 18, 1999, and before June 24, 2003. Section 1.752-

7(k)(2) describes the manner in which the election is made.

[T.D. 9207, 70 FR 30343, May 26, 2005]

§ 1.752-7 Partnership assumption of partner's § 1.752-7 liability on or after June 24, 2003.

(a) *Purpose and structure.* The purpose of this section is to prevent the acceleration or duplication of loss through the assumption of obligations not described in § 1.752-1(a)(4)(i) in transactions involving partnerships. Under paragraph (c) of this section, any such obligation that is assumed by a partnership from a partner in a transaction governed by section 721(a) is treated as section 704(c) property. Paragraphs (e), (f), and (g) of this section provide rules for situations where a partnership assumes such an obligation from a partner and, subsequently, that partner transfers all or part of the partnership interest, that partner receives a distribution in liquidation of the partnership interest, or another partner assumes part or all of that obligation from the partnership. These rules prevent the duplication of loss by prohibiting the partnership and any person other than the partner from whom the obligation was assumed from claiming a deduction, loss, or capital expense to the extent of the built-in loss associated with the obligation. These rules also prevent the acceleration of loss by deferring the partner's deduction or loss attributable to the obligation (if any) until the satisfaction of the § 1.752-7 liability (within the meaning of paragraph (b)(8) of this section). Paragraph (d) of this section provides a number of exceptions to paragraphs (e), (f), and (g) of this section, including a de minimis exception. Paragraph (i) provides a special rule for situations in which an amount paid to satisfy a § 1.752-7 liability is capitalized into other partnership property. Paragraph (j) of this section provides special rules for tiered partnership transactions.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Assumption.* The principles of § 1.752-1(d) and (e) apply in determining if a § 1.752-7 liability has been assumed.

(2) *Adjusted value.* The adjusted value of a partner's interest in a partnership

is the fair market value of that interest increased by the partner's share of partnership liabilities under §§ 1.752-1 through 1.752-5.

(3) *§ 1.752-7 liability*—(i) *In general.* A § 1.752-7 liability is an obligation described in § 1.752-1(a)(4)(ii) to the extent that either—

(A) The obligation is not described in § 1.752-1(a)(4)(i); or

(B) The amount of the obligation (under paragraph (b)(3)(ii) of this section) exceeds the amount taken into account under § 1.752-1(a)(4)(i).

(ii) *Amount and share of § 1.752-7 liability.* The amount of a § 1.752-7 liability (or, for purposes of paragraph (b)(3)(i) of this section, the amount of an obligation) is the amount of cash that a willing assignor would pay to a willing assignee to assume the § 1.752-7 liability in an arm's-length transaction. If the obligation arose under a contract in exchange for rights granted to the obligor under that contract, and those contractual rights are contributed to the partnership in connection with the partnership's assumption of the contractual obligation, then the amount of the § 1.752-7 liability or obligation is the amount of cash, if any, that a willing assignor would pay to a willing assignee to assume the entire contract. A partner's share of a partnership's § 1.752-7 liability is the amount of deduction that would be allocated to the partner with respect to the § 1.752-7 liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than § 1.752-7 liabilities), and paid an unrelated person to assume all of its § 1.752-7 liabilities in a fully taxable arm's-length transaction (assuming such payment would give rise to an immediate deduction to the partnership).

(iii) *Example.* In 2005, A, B, and C form partnership PRS. A contributes \$10,000,000 in exchange for a 25% interest in PRS and PRS's assumption of a debt obligation. The debt obligation was issued for cash and the issue price was equal to the stated redemption price at maturity (\$5,000,000). The debt obligation bears interest, payable quarterly, at a fixed rate of interest, which was a market rate of interest when the debt obligation was issued. At the time of the assumption, all accrued interest

has been paid. Prior to the partnership assuming the obligation, interest rates decrease, resulting in the debt obligation bearing an above-market interest rate. Assume that, as a result of the decline in interest rates, A would have had to pay a willing assignee \$6,000,000 to assume the debt obligation. The assumption of the debt obligation by PRS from A is treated as an assumption of a § 1.752-1(a)(4)(i) liability in the amount of \$5,000,000 (the portion of the total amount of the debt obligation that has created basis in A's assets, that is, the \$5,000,000 that was issued in exchange for the debt obligation) and an assumption of a § 1.752-7 liability in the amount of \$1,000,000 (the difference between the total obligation, \$6,000,000, and the § 1.752-1(a)(4)(i) liability, \$5,000,000).

(4) *§ 1.752-7 liability transfer*—(i) *In general.* Except as provided in paragraph (b)(4)(ii) of this section, a § 1.752-7 liability transfer is any assumption of a § 1.752-7 liability by a partnership from a partner in a transaction governed by section 721(a).

(ii) *Terminations under section 708(b)(1)(B).* In determining if a deemed contribution of assets and assumption of liability as a result of a technical termination is treated as a § 1.752-7 liability transfer, only § 1.752-7 liabilities that were assumed by the terminating partnership as part of an earlier § 1.752-7 liability transfer are taken into account and, then, only to the extent of the remaining built-in loss associated with that § 1.752-7 liability.

(5) *§ 1.752-7 liability partner*—(i) *In general.* A § 1.752-7 liability partner is a partner from whom a partnership assumes a § 1.752-7 liability as part of a § 1.752-7 liability transfer or any person who acquires a partnership interest from the § 1.752-7 liability partner in a transaction to which paragraph (e)(3) of this section applies.

(ii) *Tiered partnerships*—(A) *Assumption by a lower-tier partnership.* If, in a § 1.752-7 liability transfer, a partnership (lower-tier partnership) assumes a § 1.752-7 liability from another partnership (upper-tier partnership), then both the upper-tier partnership and the partners of the upper-tier partnership are § 1.752-7 liability partners. Therefore, paragraphs (e) and (f) of this sec-

tion apply on a sale or liquidation of any partner's interest in the upper-tier partnership and on a sale or liquidation of the upper-tier partnership's interest in the lower-tier partnership. See paragraph (j)(3) of this section. If, in a § 1.752-7 liability transfer, the upper-tier partnership assumes a § 1.752-7 liability from a partner, and, subsequently, in another § 1.752-7 liability transfer, a lower-tier partnership assumes that § 1.752-7 liability from the upper-tier partnership, then the partner from whom the upper-tier partnership assumed the § 1.752-7 liability continues to be the § 1.752-7 liability partner of the lower-tier partnership with respect to the remaining built-in loss associated with that § 1.752-7 liability. Any new built-in loss associated with the § 1.752-7 liability that is created on the assumption of the § 1.752-7 liability from the upper-tier partnership by the lower-tier partnership is shared by all the partners of the upper-tier partnership in accordance with their interests in the upper-tier partnership, and each partner of the upper-tier partnership is treated as a § 1.752-7 liability partner with respect to that new built-in loss. See paragraph (e)(3)(ii), *Example 3* of this section.

(B) *Distribution of partnership interest.* If, in a transaction described in § 1.752-7(e)(3), an interest in a partnership (lower-tier partnership) that has assumed a § 1.752-7 liability is distributed by a partnership (upper-tier partnership) that is the § 1.752-7 liability partner with respect to that liability, then the persons receiving interests in the lower-tier partnership are § 1.752-7 liability partners with respect to the lower-tier partnership to the same extent that they were prior to the distribution.

(6) *Remaining built-in loss associated with a § 1.752-7 liability.* (i) *In general.* The remaining built-in loss associated with a § 1.752-7 liability equals the amount of the § 1.752-7 liability as of the time of the assumption of the § 1.752-7 liability by the partnership, reduced by the portion of the § 1.752-7 liability previously taken into account by the § 1.752-7 liability partner under paragraph (j)(3) of this section and adjusted as provided in paragraph (c) of this section and § 1.704-3 for—

(A) Any portion of that built-in loss associated with the §1.752-7 liability that is satisfied by the partnership on or prior to the testing date (whether capitalized or deducted); and

(B) Any assumption of all or part of the §1.752-7 liability by the §1.752-7 liability partner (including any assumption that occurs on the testing date).

(ii) *Partial dispositions and assumptions.* In the case of a partial disposition of the §1.752-7 liability partner's partnership interest or a partial assumption of the §1.752-7 liability by another partner, the remaining built-in loss associated with §1.752-7 liability is pro rated based on the portion of the interest sold or the portion of the §1.752-7 liability assumed.

(7) *§1.752-7 liability reduction*—(i) *In general.* The §1.752-7 liability reduction is the amount by which the §1.752-7 liability partner is required to reduce the basis in the partner's partnership interest by operation of paragraphs (e), (f), and (g) of this section. The §1.752-7 liability reduction is the lesser of—

(A) The excess of the §1.752-7 liability partner's basis in the partnership interest over the adjusted value of that interest (as defined in paragraph (b)(2) of this section); or

(B) The remaining built-in loss associated with the §1.752-7 liability (as defined in paragraph (b)(6) of this section without regard to paragraph (b)(6)(ii) of this section).

(ii) *Partial dispositions and assumptions.* In the case of a partial disposition of the §1.752-7 liability partner's partnership interest or a partial assumption of the §1.752-7 liability by another partner, the §1.752-7 liability reduction is pro rated based on the portion of the interest sold or the portion of the §1.752-7 liability assumed.

(8) *Satisfaction of §1.752-7 liability*—*In general.* A §1.752-7 liability is treated as satisfied (in whole or in part) on the date on which the partnership (or the assuming partner) would have been allowed to take the §1.752-7 liability into account for federal tax purposes but for this section. For example, a §1.752-7 liability is treated as satisfied when, but for this section, the §1.752-7 liability would give rise to—

(i) An increase in the basis of the partnership's or the assuming partner's assets (including cash);

(ii) An immediate deduction to the partnership or to the assuming partner;

(iii) An expense that is not deductible in computing the partnership's or the assuming partner's taxable income and not properly chargeable to capital account; or

(iv) An amount realized on the sale or other disposition of property subject to that liability if the property was disposed of by the partnership or the assuming partner at that time.

(9) *Testing date.* The testing date is—

(i) For purposes of paragraph (e) of this section, the date of the sale, exchange, or other disposition of part or all of the §1.752-7 liability partner's partnership interest;

(ii) For purposes of paragraph (f) of this section, the date of the partnership's distribution in liquidation of the §1.752-7 liability partner's partnership interest; and

(iii) For purposes of paragraph (g) of this section, the date of the assumption (or partial assumption) of the §1.752-7 liability by a partner other than the §1.752-7 liability partner.

(10) *Trade or business*—(i) *In general.* A trade or business is a specific group of activities carried on by a person for the purpose of earning income or profit, other than a group of activities consisting of acquiring, holding, dealing in, or disposing of financial instruments, if the activities included in that group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily includes the collection of income and the payment of expenses. The group of activities must constitute the carrying on of a trade or business under section 162(a) (determined as though the activities were conducted by an individual).

(ii) *Examples.* The following examples illustrate the provisions of this paragraph (b)(10):

Example 1. Corporation Y owns, manages, and derives rental income from an office building and also owns vacant land that may be subject to environmental liabilities. Corporation Y contributes the land subject to the environmental liabilities to PRS in a

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transaction governed by section 721(a). PRS plans to develop the land as a landfill. The contribution of the vacant land does not constitute the contribution of a trade or business because Corporation Y did not conduct any significant business or development activities with respect to the land prior to the contribution.

Example 2. For the past 5 years, Corporation X has owned and operated gas stations in City A, City B, and City C. Corporation X transfers all of the assets associated with the operation of the gas station in City A to PRS for interests in PRS and the assumption by PRS of the § 1.752-7 liabilities associated with that gas station. PRS continues to operate the gas station in City A after the contribution. The contribution of the gas station to PRS constitutes the contribution of a trade or business.

Example 3. For the past 7 years, Corporation Z has engaged in the manufacture and sale of household products. Throughout this period, Corporation Z has maintained a research department for use in connection with its manufacturing activities. The research department has 10 employees actively engaged in the development of new products. Corporation Z contributes the research department to PRS in exchange for a PRS interest and the assumption by PRS of pension liabilities with respect to the employees of the research department. PRS continues the research operations on a contractual basis with several businesses, including Corporation Z. The contribution of the research operations to PRS constitutes a contribution of a trade or business.

(c) *Application of section 704(b) and (c) to assumed § 1.752-7 liabilities—(1) In general—(i) Section 704(c).* Except as otherwise provided in this section, sections 704(c)(1)(A) and (B), section 737, and the regulations thereunder, apply to § 1.752-7 liabilities. See § 1.704-3(a)(12). However, § 1.704-3(a)(7) does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which paragraph (e)(1) of this section applies.

(ii) *Section 704(b).* Section 704(b) and § 1.704-1(b) apply to a post-contribution change in the value of a § 1.752-7 liability. If there is a decrease in the value of a § 1.752-7 liability that is reflected in the capital accounts of the partners under § 1.704-1(b)(2)(iv)(f), the amount of the decrease constitutes an item of income for purposes of section 704(b) and § 1.704-1(b). Conversely, if there is an increase in the value of a § 1.752-7 liability that is reflected in the capital accounts of the partners under § 1.704-1(b)(2)(iv)(f), the amount of the increase constitutes an item of loss for purposes of section 704(b) and § 1.704-1(b).

(2) *Example.* The following example illustrates the provisions of this paragraph (c):

Example. (i) Facts. In 2004, A, B, and C form partnership PRS. A contributes Property 1 with a fair market value and basis of \$400X, subject to a § 1.752-7 liability of \$100X, for a 25% interest in PRS. B contributes \$300X cash for a 25% interest in PRS, and C contributes \$600X cash for a 50% interest in PRS. Assume that the partnership complies with the substantial economic effect safe harbor of § 1.704-1(b)(2). Under § 1.704-1(b)(2)(iv)(b), A's capital account is credited with \$300X (the fair market value of Property 1, \$400X, less the § 1.752-7 liability assumed by PRS, \$100X). In accordance with §§ 1.752-7(c)(1)(i) and 1.704-3, the partnership can use any reasonable method for section 704(c) purposes. In this case, the partnership elects the traditional method under § 1.704-3(b) and also elects to treat the deductions or losses attributable to the § 1.752-7 liability as coming first from the built-in loss. In 2005, PRS earns \$200X of income and uses it to satisfy the § 1.752-7 liability which has increased in value to \$200X. Assume that the cost to PRS of satisfying the § 1.752-7 liability is deductible by PRS. The \$200X of partnership income is allocated according to the partnership agreement, \$50X to A, \$50X to B, and \$100X to C.

A		B		C		
Book	Tax	Book	Tax	Book	Tax	
\$300	\$400	\$300	\$300	\$600	\$600	Initial Contribution
50	50	50	50	100	100	Income
(25)	(125)	(25)	(25)	(50)	(50)	Satisfaction of Liability
\$325	\$325	\$325	\$325	\$650	\$650	

(ii) *Analysis.* Pursuant to paragraph (c) of this section, \$100X of the deduction attributable to the satisfaction of the §1.752-7 liability is specially allocated to A, the §1.752-7 liability partner, under section 704(c)(1)(A) and §1.704-3. No book item corresponds to this tax allocation. The remaining \$100X of deduction attributable to the satisfaction of the §1.752-7 liability is allocated, for both book and tax purposes, according to the partnership agreement, \$25X to A, \$25X to B, and \$50X to C. If the partnership, instead, satisfied the §1.752-7 liability over a number of years, the first \$100X of deduction with respect to the §1.752-7 liability would be allocated to A, the §1.752-7 liability partner, before any deduction with respect to the §1.752-7 liability would be allocated to the other partners. For example, if PRS were to satisfy \$50X of the §1.752-7 liability, the \$50X deduction with respect to the §1.752-7 liability would be allocated to A for tax purposes only. No deduction would arise for book purposes. If PRS later paid a further \$100X in satisfaction of the §1.752-7 liability, \$50X of the deduction with respect to the §1.752-7 liability would be allocated, solely for tax purposes, to A and the remaining \$50X would be allocated, for both book and tax purposes, according to the partnership agreement. Under these circumstances, the partnership's method of allocating the built-in loss associated with the §1.752-7 liability is reasonable.

(d) *Special rules for transfers of partnership interests, distributions of partnership assets, and assumptions of the §1.752-7 liability after a §1.752-7 liability transfer—(1) In general.* Except as provided in paragraphs (d)(2) and (i) of this section, paragraphs (e), (f), and (g) of this section apply to certain partnership transactions occurring after a §1.752-7 liability transfer.

(2) *Exceptions—(i) In general.* Paragraphs (e), (f), and (g) of this section do not apply—

(A) If the partnership assumes the §1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution (for the definition of a

trade or business, see paragraph (b)(10) of this section); or

(B) If, immediately before the testing date, the amount of the remaining built-in loss with respect to all §1.752-7 liabilities assumed by the partnership (other than §1.752-7 liabilities assumed by the partnership with an associated trade or business) in one or more §1.752-7 liability transfers is less than the lesser of 10% of the gross value of partnership assets or \$1,000,000.

(ii) *Examples.* The following examples illustrate the principles of this paragraph (d)(2):

Example 1. For the past 5 years, Corporation X, a C corporation, has been engaged in Business A and Business B. In 2004, Corporation X contributes Business A, in a transaction governed by section 721(a), to PRS in exchange for a PRS interest and the assumption by PRS of pension liabilities with respect to the employees engaged in Business A. PRS plans to carry on Business A after the contribution. Because PRS has assumed the pension liabilities as part of a contribution to PRS of the trade or business with which the liabilities are associated, the treatment of the pension liabilities is not affected by paragraphs (e), (f), and (g) of this section with respect to any transaction occurring after the §1.752-7 liability transfer of the pension liabilities.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that PRS also assumes from Corporation X certain pension liabilities with respect to the employees of Business B. At the time of the assumption, the amount of the pension liabilities with respect to the employees of Business A is \$3,000,000 (the A liabilities) and the amount of the pension liabilities associated with the employees of Business B (the B liabilities) is \$2,000,000. Two years later, Corporation X sells its interest in PRS to Y for \$9,000,000. At the time of the sale, the remaining built-in loss associated with the A liabilities is \$2,100,000, the remaining built-in loss associated with the B liabilities is \$900,000, and the gross value of PRS's assets (excluding §1.752-7 liabilities) is \$20,000,000. Assume that PRS has no §1.752-7 liabilities other than those assumed from Corporation X.

PRS Balance Sheet at Time of X's Sale of PRS Interest
(in millions)

<u>Assets</u>	<u>Liabilities</u>	
\$20		Gross Assets
		(including Business A)
	(\$2.1)	A Liabilities
	(0.9)	B Liabilities

(ii) *Analysis.* The only liabilities assumed by PRS from Corporation X that were not assumed as part of Corporation X's contribution of Business A were the B liabilities. Immediately before the testing date, the remaining built-in loss associated with the B liabilities (\$900,000) was less than the lesser of 10% of the gross value of PRS's assets (\$2,000,000) or \$1,000,000. Therefore, paragraph (d)(2)(i)(B) of this section applies to exclude Corporation X's sale of the PRS interest to Y from the application of paragraph (e) of this section.

(e) *Transfer of § 1.752-7 liability partner's partnership interest—(1) In general.* Except as provided in paragraphs (d)(2), (e)(3), and (i) of this section, immediately before the sale, exchange, or other disposition of all or a part of a § 1.752-7 liability partner's partnership interest, the § 1.752-7 liability partner's basis in the partnership interest is reduced by the § 1.752-7 liability reduction (as defined in paragraph (b)(7) of this section). No deduction, loss, or capital expense is allowed to the partnership on the satisfaction of the § 1.752-7 liability (within the meaning of paragraph (b)(8) of this section) to the extent of the remaining built-in loss associated with the § 1.752-7 liability (as defined in paragraph (b)(6) of this section). For purposes of section 705(a)(2)(B) and § 1.704-1(b)(2)(ii)(b) only, the remaining built-in loss associated with the § 1.752-7 liability is not treated as a nondeductible, noncapital expenditure of the partnership. Therefore, the remaining partners' capital accounts and bases in their partnership interests are not reduced by the remaining built-in loss associated with the § 1.752-7 liability. If the partnership (or any successor) notifies the § 1.752-7 liability partner of the satisfaction of the § 1.752-7 liability, then the § 1.752-7 liability partner is entitled to a loss or deduction. The amount of that deduc-

tion or loss is, in the case of a partial satisfaction of the § 1.752-7 liability, the amount that the partnership would, but for this section, take into account on the partial satisfaction of the § 1.752-7 liability (but not, in total, more than the § 1.752-7 liability reduction) or, in the case of a complete satisfaction of the § 1.752-7 liability, the remaining § 1.752-7 liability reduction. To the extent of the amount that the partnership would, but for this section, take into account on the satisfaction of the § 1.752-7 liability, the character of that deduction or loss is determined as if the § 1.752-7 liability partner had satisfied the liability. To the extent that the § 1.752-7 liability reduction exceeds the amount that the partnership would, but for this section, take into account on the satisfaction of the § 1.752-7 liability, the character of the § 1.752-7 liability partner's loss is capital.

(2) *Examples.* The following examples illustrate the principles of paragraph (e)(1) of this section:

Example 1. (i) *Facts.* In 2004, A, B, and C form partnership PRS. A contributes Property 1 with a fair market value of \$5,000,000 and basis of \$4,000,000 subject to a § 1.752-7 liability of \$2,000,000 in exchange for a 25% interest in PRS. B contributes \$3,000,000 cash in exchange for a 25% interest in PRS, and C contributes \$6,000,000 cash in exchange for a 50% interest in PRS. In 2006, when PRS has a section 754 election in effect, A sells A's interest in PRS to D for \$3,000,000. At the time of the sale, the basis of A's PRS interest is \$4,000,000, the remaining built-in loss associated with the § 1.752-7 liability is \$2,000,000, and PRS has no liabilities (as defined in § 1.752-1(a)(4)). Assume that none of the exceptions of paragraph (d)(2) of this section apply and that the satisfaction of the § 1.752-7 liability would have given rise to a deductible expense to A. In 2007, PRS pays \$3,000,000 to satisfy the liability.

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PRS Balance Sheet (in millions)

Assets			Liabilities/Equity		
Value	Basis		Value	Basis	
\$5	\$4	Property 1			
\$9	\$9	Cash	\$2	-	\$1.752-7 Liability
					Partner's Equity:
			\$3	\$4	A
			\$3	\$3	B
			\$6	\$6	C

(ii) *Sale of A's PRS interest.* Immediately before the sale of the PRS interest to D, A's basis in the PRS interest is reduced (to \$3,000,000) by the §1.752-7 liability reduction, i.e., the lesser of the excess of A's basis in the PRS interest (\$4,000,000) over the adjusted value of that interest (\$3,000,000), \$1,000,000, or the remaining built-in loss associated with the §1.752-7 liability, \$2,000,000. Therefore, A neither realizes nor recognizes any gain or loss on the sale of the PRS interest to D. D's basis in the PRS interest is \$3,000,000. D's share of the adjusted basis of

partnership property, as determined under §1.743-1(d), equals D's interest in the partnership's previously taxed capital of \$2,000,000 (the amount of cash that D would receive on a liquidation of the partnership, \$3,000,000, increased by the amount of tax loss that would be allocated to D in the hypothetical transaction, \$0, and reduced by the amount of tax gain that would be allocated to D in the hypothetical transaction, \$1,000,000). Therefore, the positive basis adjustment under section 743(b) is \$1,000,000.

Computation of §1.752-7 Liability Reduction (in millions)

1. Basis of A's PRS interest	\$4
2. Less adjusted value of A's PRS interest	(3)
3. Difference	\$1
4. Remaining built-in loss from §1.752-7 liability	2
5. §1.752-7 liability reduction (lesser of 3 or 4)	\$1

Gain/Loss on Sale of A's PRS Interest (in millions)

1. Amount realized on sale	\$3
2. Less basis of PRS interest	
Original	4
§1.752-7 liability reduction	1
Difference	(3)
3. Gain/Loss	0

(iii) *Satisfaction of §1.752-7 liability.* Neither PRS nor any of its partners is entitled to a deduction, loss, or capital expense upon the satisfaction of the §1.752-7 liability to the extent of the remaining built-in loss associated with the §1.752-7 liability (\$2,000,000). PRS is entitled to a deduction, however, for the amount by which the cost of satisfying the §1.752-7 liability exceeds the remaining

built-in loss associated with the §1.752-7 liability. Therefore, in 2007, PRS may deduct \$1,000,000 (cost to satisfy the §1.752-7 liability, \$3,000,000, less the remaining built-in loss associated with the §1.752-7 liability, \$2,000,000). If PRS notifies A of the satisfaction of the §1.752-7 liability, then A is entitled to an ordinary deduction in 2007 of \$1,000,000 (the §1.752-7 liability reduction).

PRS's Deduction on Satisfaction of Liability (in millions)

1. Amount paid by PRS to satisfy §1.752-7 liability	\$3
2. Remaining built-in loss for §1.752-7 liability	<u>(2)</u>
3. Difference	<u>\$1</u>

Example 2. The facts are the same as in *Example 1* except that, at the time of A's sale of the PRS interest to D, PRS has a non-recourse liability of \$4,000,000, of which A's share is \$1,000,000. A's basis in PRS is \$5,000,000. At the time of the sale of the PRS interest to D, the adjusted value of A's interest is \$4,000,000 (the fair market value of the interest (\$3,000,000), increased by A's share of partnership liabilities (\$1,000,000)). The difference between the basis of A's interest (\$5,000,000) and the adjusted value of that interest (\$4,000,000) is \$1,000,000. Therefore, the §1.752-7 liability reduction is \$1,000,000 (the lesser of this difference or the remaining built-in loss associated with the §1.752-7 li-

ability, \$2,000,000). Immediately before the sale of the PRS interest to D, A's basis is reduced from \$5,000,000 to \$4,000,000. A's amount realized on the sale of the PRS interest to D is \$4,000,000 (\$3,000,000 paid by D, increased under section 752(d) by A's share of partnership liabilities, or \$1,000,000). Therefore, A neither realizes nor recognizes any gain or loss on the sale. D's basis in the PRS interest is \$4,000,000. Because D's share of the adjusted basis of partnership property is \$3,000,000 (D's share of the partnership's previously taxed capital, \$2,000,000, plus D's share of partnership liabilities, \$1,000,000), the basis adjustment under section 743(b) is \$1,000,000.

PRS Balance Sheet (in millions)

<u>Assets</u>			<u>Liabilities/Equity</u>		
<u>Value</u>	<u>Basis</u>		<u>Value</u>	<u>Basis</u>	
\$ 5	\$ 4	Property 1			
\$13	\$13	Cash	\$4	-	Nonrecourse Debt
			\$2	-	§1.752-7 Liability
					Partner's Equity:
			\$3	\$5	A
			\$3	\$4	B
			\$6	\$8	C

Computation of §1.752-7 Liability Reduction (in millions)

1. Basis of A's PRS interest	\$5
2. Less adjusted value of A's PRS interest	
Value of PRS interest	3
A's share of nonrecourse debt	1
Total	<u>(4)</u>
3. Difference between 1 and 2	1
4. Remaining built-in loss	
from §1.752-7 liability	<u>2</u>
5. §1.752-7 liability reduction	
(lesser of 3 or 4)	\$1

Gain/Loss on Sale of A's PRS Interest (in millions)

1. Amount realized on sale	
Value of PRS interest	\$3
A's share of nonrecourse debt	1
Total	<u>\$4</u>
2. Less basis of PRS interest	
Original	\$5
§1.752-7 liability reduction	1
Difference	<u>(\$4)</u>
3. Gain/Loss	0

Example 3. The facts are the same as in *Example 1*, except that the satisfaction of the §1.752-7 liability would have given rise to a capital expense to A or PRS. Neither PRS nor any of its partners are entitled to a capital expense upon the satisfaction of the §1.752-7 liability to the extent of the remaining built-in loss associated with the §1.752-7 liability (\$2,000,000). PRS may, however, increase the basis of appropriate partnership assets by the amount by which the cost of satisfying the §1.752-7 liability exceeds the remaining built-in loss associated with the §1.752-7 liability. Therefore, in 2007, PRS may capitalize \$1,000,000 (cost to satisfy the §1.752-7 liability, \$3,000,000, less the remaining built-in loss associated with the §1.752-7 liability, \$2,000,000) to the appropriate partnership assets. If A is notified by PRS that the §1.752-7 liability has been satisfied, then A is entitled to a capital loss in 2007 as provided in paragraph (e)(1) of this section, the year of the satisfaction of the §1.752-7 liability.

(3) *Exception for nonrecognition transactions*—(i) *In general.* Paragraph (e)(1) of this section does not apply where a §1.752-7 liability partner transfers all or part of the partner's partnership interest in a transaction in which the

transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the partnership interest. In addition, paragraph (e)(1) of this section does not apply to a distribution of an interest in the partnership (lower-tier partnership) that has assumed the §1.752-7 liability by a partnership that is the §1.752-7 liability partner (upper-tier partnership) if the partners of the upper-tier partnership that were §1.752-7 liability partners with respect to the lower-tier partnership prior to the distribution continue to be §1.752-7 liability partners with respect to the lower-tier partnership after the distribution. See paragraphs (b)(4)(ii) and (j)(3) of this section for rules on the application of this section to partners of the §1.752-7 liability partner.

(ii) *Examples.* The following examples illustrate the provisions of this paragraph (e)(3):

Example 1. Transfer of partnership interest to lower-tier partnership. (i) *Facts.* In 2004, X contributes undeveloped land with a value and

basis of \$2,000,000 and subject to environmental liabilities of \$1,500,000 to partnership LTP in exchange for a 50% interest in LTP. LTP develops the land as a landfill. In 2005, in a transaction governed by section 721(a), X contributes the LTP interest to UTP in exchange for a 50% interest in UTP. In 2008, X sells the UTP interest to A for \$500,000. At the time of the sale, X's basis in UTP is \$2,000,000, the remaining built-in loss associated with the environmental liability is \$1,500,000, and the gross value of UTP's assets is \$2,500,000. The environmental liabilities were not assumed by LTP as part of a contribution by X to LTP of a trade or business with which the liabilities were associated. (See paragraph (b)(10)(ii), *Example 1* of this section.)

(i) *Analysis.* Because UTP's basis in the LTP interest is determined by reference to X's basis in the LTP interest, X's contribution of the LTP interest to UTP is exempted from the rules of paragraph (e)(1) of this section. Under paragraph (j)(1) of this section, X's contribution of the LTP interest to UTP is treated as a contribution of X's share of the assets of LTP and UTP's assumption of X's share of the LTP liabilities (including § 1.752-7 liabilities). Therefore, X's transfer of the LTP interest to UTP is a § 1.752-7 liability transfer. The § 1.752-7 liabilities deemed transferred by X to UTP are not associated with a trade or business transferred to UTP for purposes of paragraph (d)(2)(i)(A) of this section, because they were not associated with a trade or business transferred by X to LTP as part of the original § 1.752-7 liability transfer. See paragraph (j)(2) of this section. Because none of the exceptions described in paragraph (d)(2) of this section apply to X's taxable sale of the UTP interest to A in 2008, paragraph (e)(1) of this section applies to that sale.

Example 2. Transfer of partnership interest to corporation. The facts are the same as in *Example 1*, except that, rather than transferring the LTP interest to UTP in 2005, X contributes the LTP interest to Corporation Y in an exchange to which section 351 applies. Because Corporation Y's basis in the LTP interest is determined by reference to X's basis in that interest, X's contribution of the LTP interest is exempted from the rules of paragraph (e)(1) of this section. But see section 358(h) and § 1.358-7 for appropriate basis adjustments.

Example 3. Partnership merger. (i) *Facts.* In 2004, A, B, C, and D form equal partnership PRS1. A contributes Blackacre with a value and basis of \$2,000,000 to PRS1 and PRS1 assumes from A \$1,500,000 of pension liabilities unrelated to Blackacre. B, C, and D each contribute \$500,000 cash to PRS1. PRS1 uses the cash contributed by B, C, and D (\$1,500,000) to purchase Whiteacre. In 2006, PRS1 merges into PRS2 in an assets-over merger under § 1.708-1(c)(3). Assume that,

under § 1.708-1(c), PRS2 is the surviving partnership and PRS1 is the terminating partnership. At the time of the merger, the value of Blackacre is still \$2,000,000, the remaining built-in loss with respect to the pension liabilities is still \$1,500,000, but the value of Whiteacre has declined to \$500,000.

(ii) *Deemed assumption by PRS2 of PRS1 liabilities.* Under § 1.708-1(c)(3), the merger is treated as a contribution of the assets and liabilities of PRS1 to PRS2, followed by a distribution of the PRS2 interests by PRS1 in liquidation of PRS1. Because PRS2 assumes a § 1.752-7 liability (the pension liabilities) of PRS1, PRS1 is a § 1.752-7 liability partner of PRS2. Under paragraph (b)(5)(ii)(A) of this section, A is also § 1.752-7 liability partner of PRS2 to the extent of the remaining \$1,500,000 built-in loss associated with the pension liabilities. B, C, and D are not § 1.752-7 liability partners with respect to PRS1. If the amount of the pension liabilities had increased between the date of PRS1's assumption of those liabilities from A and the date of the merger of PRS1 into PRS2, then B, C, and D would be § 1.752-7 liability partners with respect to PRS2 to the extent of their respective shares of that increase. See paragraph (b)(5)(ii) of this section.

(iii) *Deemed distribution of PRS2 interests.* Paragraph (e)(1) does not apply to PRS1's deemed distribution of the PRS2 interests, because, under paragraph (b)(5)(ii)(B) of this section, all of the partners that were § 1.752-7 liability partners with respect to PRS2 before the distribution, i.e., A, continue to be § 1.752-7 liability partners after the distribution. After the distribution, A's share of the pension liabilities now held by PRS2 will continue to be \$1,500,000.

Example 4. Partnership division; no shifting of § 1.752-7 liability. The facts are the same as in *Example 3*, except that PRS1 does not merge with PRS2, but instead contributes Blackacre to PRS2 in exchange for PRS2 interests and the assumption by PRS2 of the pension liabilities. Immediately thereafter, PRS1 distributes the PRS2 interests to A and B in liquidation of their interests in PRS1. The analysis is the same as in *Example 3*. After the assumption of the pension liabilities by PRS2, A is a § 1.752-7 liability partner with respect to PRS2. After the distribution of a PRS2 interest to A, A continues to be a § 1.752-7 liability partner with respect to PRS2, and the amount of A's built-in loss with respect to the § 1.752-7 liabilities continues to be \$1,500,000. Therefore, paragraph (e)(1) of this section does not apply to the distribution of the PRS2 interests to A and B.

Example 5. Partnership division; shifting of § 1.752-7 liability. The facts are the same as in *Example 4*, except that PRS1 distributes the PRS2 interests not to A and B, but to C and D, in liquidation of their interests in PRS1. After this distribution, A does not continue

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to be a § 1.752-7 liability partner of PRS2, because A no longer has an interest in PRS2. Therefore, paragraph (e)(1) of this section applies to the distribution of the PRS2 interests to C and D.

(f) *Distribution in liquidation of § 1.752-7 liability partner's partnership interest—*
 (1) *In general.* Except as provided in paragraphs (d)(2) and (i) of this section, immediately before a distribution in liquidation of a § 1.752-7 liability partner's partnership interest, the § 1.752-7 liability partner's basis in the partnership interest is reduced by the § 1.752-7 liability reduction (as defined in paragraph (b)(7) of this section). This rule applies before section 737. No deduction, loss, or capital expense is allowed to the partnership on the satisfaction of the § 1.752-7 liability (within the meaning of paragraph (b)(8) of this section) to the extent of the remaining built-in loss associated with the § 1.752-7 liability (as defined in paragraph (b)(6) of this section). For purposes of section 705(a)(2)(B) and § 1.704-1(b)(2)(ii)(b) only, the remaining built-in loss associated with the § 1.752-7 liability is not treated as a nondeductible, noncapital expenditure of the partnership. Therefore, the remaining partners' capital accounts and bases in their partnership interests are not reduced by the remaining built-in loss associated with the § 1.752-7 liability. If the partnership (or any successor) notifies the § 1.752-7 liability partner of the satisfaction of the § 1.752-7 liability, then the § 1.752-7 liability partner is entitled to a loss or deduction. The amount of that deduction or loss is, in the case of a partial satisfaction of the § 1.752-7 liability, the amount that the partnership would, but for this section,

take into account on the partial satisfaction of the § 1.752-7 liability (but not, in total, more than the § 1.752-7 liability reduction) or, in the case of a complete satisfaction of the § 1.752-7 liability, the remaining § 1.752-7 liability reduction. To the extent of the amount that the partnership would, but for this section, take into account on satisfaction of the § 1.752-7 liability, the character of that deduction or loss is determined as if the § 1.752-7 liability partner had satisfied the liability. To the extent that the § 1.752-7 liability reduction exceeds the amount that the partnership would, but for this section, take into account on satisfaction of the § 1.752-7 liability, the character of the § 1.752-7 liability partner's loss is capital.

(2) *Example.* The following example illustrates the provision of this paragraph (f):

Example. (i) Facts. In 2004, A, B, and C form partnership PRS. A contributes Property 1 with a fair market value and basis of \$5,000,000 subject to a § 1.752-7 liability of \$2,000,000 for a 25% interest in PRS. B contributes \$3,000,000 cash for a 25% interest in PRS, and C contributes \$6,000,000 cash for a 50% interest in PRS. In 2012, when PRS has a section 754 election in effect, PRS distributes Property 2, which has a basis and fair market value of \$3,000,000, to A in liquidation of A's PRS interest. At the time of the distribution, the fair market value of A's PRS interest is still \$3,000,000, the basis of that interest is still \$5,000,000, and the remaining built-in loss associated with the § 1.752-7 liability is still \$2,000,000. Assume that none of the exceptions of paragraph (d)(2) of this section apply to the distribution and that the satisfaction of the § 1.752-7 liability would have given rise to a deductible expense to A. In 2013, PRS pays \$1,000,000 to satisfy the entire § 1.752-7 liability.

PRS Balance Sheet (in millions)

<u>Assets</u>		<u>Liabilities/Equity</u>		
<u>Value</u>	<u>Basis</u>	<u>Value</u>	<u>Basis</u>	
\$5	\$5			Property 1
\$9	\$9			Cash
		\$2	-	§1.752-7 Liability
		\$3	\$5	Partner's Equity:
		\$3	\$3	A
		\$6	\$6	B
				C

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(ii) *Liquidation of A's PRS interest.* Immediately before the distribution of Property 2 to A, A's basis in the PRS interest is reduced (to \$3,000,000) by the §1.752-7 liability reduction, *i.e.*, the lesser of the excess of A's basis in the PRS interest (\$5,000,000) over the adjusted value (\$3,000,000) of that interest (\$2,000,000) or the remaining built-in loss as-

sociated with the §1.752-7 liability (\$2,000,000). Therefore, A's basis in Property 2 under section 732(b) is \$3,000,000. Because this is the same as the partnership's basis in Property 2 immediately before the distribution, the partnership's basis adjustment under section 734(b) is \$0.

Computation of §1.752-7 Liability Reduction (in millions)

1. Basis of A's PRS interest	\$5
2. Less adjusted value of A's PRS interest	(3)
3. Difference	<u>\$2</u>
4. Remaining built-in loss from §1.752-7 liability	<u>2</u>
5. §1.752-7 liability reduction (lesser of 3 or 4)	\$2

(iii) *Satisfaction of §1.752-7 liability.* PRS is not entitled to a deduction, loss, or capital expense on the satisfaction of the §1.752-7 liability to the extent of the remaining built-in loss associated with the §1.752-7 liability (\$2,000,000). Because this amount exceeds the amount paid by PRS to satisfy the §1.752-7 liability (\$1,000,000), PRS is not entitled to

any deduction for the §1.752-7 liability in 2013. If, however, PRS notifies A of the satisfaction of the §1.752-7 liability, A is entitled to an ordinary deduction in 2013 of \$1,000,000 (the amount paid in satisfaction of the §1.752-7 liability) and a capital loss of \$1,000,000 (the remaining §1.752-7 liability reduction).

PRS's Deduction on Satisfaction of Liability (in millions)

Amount paid by PRS to satisfy §1.752-7 liability	\$1
Remaining built-in loss for §1.752-7 liability	(2)
Difference (but not below zero)	<u>\$0</u>

(g) *Assumption of §1.752-7 liability by a partner other than §1.752-7 liability partner—(1) In general.* If this paragraph (g) applies, section 704(c)(1)(B) does not apply to an assumption of a §1.752-7 liability from a partnership by a partner other than the §1.752-7 liability partner. The rules of paragraph (g)(2) of this section apply only if the §1.752-7 liability partner is a partner in the partnership at the time of the assumption of the §1.752-7 liability from the partnership. The rules of paragraphs (g)(3) and (4) of this section apply to any assumption of the §1.752-7 liability by a partner other than the §1.752-7 liability partner, whether or not the §1.752-7 liability partner is a partner in

the partnership at the time of the assumption from the partnership.

(2) *Consequences to §1.752-7 liability partner.* If, at the time of an assumption of a §1.752-7 liability from a partnership by a partner other than the §1.752-7 liability partner, the §1.752-7 liability partner remains a partner in the partnership, then the §1.752-7 liability partner's basis in the partnership interest is reduced by the §1.752-7 liability reduction (as defined in paragraph (b)(7) of this section). If the assuming partner (or any successor) notifies the §1.752-7 liability partner of the satisfaction of the §1.752-7 liability (within the meaning of paragraph (b)(8)

of this section), then the § 1.752-7 liability partner is entitled to a deduction or loss. The amount of that deduction or loss is, in the case of a partial satisfaction of the § 1.752-7 liability, the amount that the assuming partner would, but for this section, take into account on the satisfaction of the § 1.752-7 liability (but not, in total, more than the § 1.752-7 liability reduction) or, in the case of a complete satisfaction of the § 1.752-7 liability, the remaining § 1.752-7 liability reduction. To the extent of the amount that the assuming partner would, but for this section, take into account on the satisfaction of the § 1.752-7 liability, the character of that deduction or loss is determined as if the § 1.752-7 liability partner had satisfied the liability. To the extent that the § 1.752-7 liability reduction exceeds the amount that the assuming partner would, but for this section, take into account on the satisfaction of the § 1.752-7 liability, the character of the § 1.752-7 liability partner's loss is capital.

(3) *Consequences to partnership.* Immediately after the assumption of the § 1.752-7 liability from the partnership by a partner other than the § 1.752-7 liability partner, the partnership must reduce the basis of partnership assets by the remaining built-in loss associated with the § 1.752-7 liability (as defined in paragraph (b)(6) of this section). The reduction in the basis of partnership assets must be allocated among partnership assets as if that adjustment were a basis adjustment under section 734(b).

(4) *Consequences to assuming partner.* No deduction, loss, or capital expense is allowed to an assuming partner (other than the § 1.752-7 liability partner) on the satisfaction of the § 1.752-7 liability assumed from a partnership to the extent of the remaining built-in loss associated with the § 1.752-7 liability. Instead, upon the satisfaction of the § 1.752-7 liability, the assuming

partner must adjust the basis of the partnership interest, any assets (other than cash, accounts receivable, or inventory) distributed by the partnership to the partner, or gain or loss on the disposition of the partnership interest, as the case may be. These adjustments are determined as if the assuming partner's basis in the partnership interest at the time of the assumption were increased by the lesser of the amount paid (or to be paid) to satisfy the § 1.752-7 liability or the remaining built-in loss associated with the § 1.752-7 liability. However, the assuming partner cannot take into account any adjustments to depreciable basis, reduction in gain, or increase in loss until the satisfaction of the § 1.752-7 liability.

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

Example. (i) *Facts.* In 2004, A, B, and C form partnership PRS. A contributes Property 1, a nondepreciable capital asset with a fair market value and basis of \$5,000,000, in exchange for a 25% interest in PRS and assumption by PRS of a § 1.752-7 liability of \$2,000,000. B contributes \$3,000,000 cash for a 25% interest in PRS, and C contributes \$6,000,000 cash for a 50% interest in PRS. PRS uses the cash contributed to purchase Property 2. In 2007, PRS distributes Property 1, subject to the § 1.752-7 liability to B in liquidation of B's interest in PRS. At the time of the distribution, A's interest in PRS still has a value of \$3,000,000 and a basis of \$5,000,000, and B's interest in PRS still has a value and basis of \$3,000,000. Also at that time, Property 1 still has a value and basis of \$5,000,000, Property 2 still has a value and basis of \$9,000,000, and the remaining built-in loss associated with the § 1.752-7 liability still is \$2,000,000. Assume that none of the exceptions of paragraph (d)(2)(i) of this section apply to the assumption of the § 1.752-7 liability by B and that the satisfaction of the § 1.752-7 liability by A would have given rise to a deductible expense to A. In 2010, B pays \$1,000,000 to satisfy the entire § 1.752-7 liability. At that time, B still owns Property 1, which has a basis of \$3,000,000.

PRS Balance Sheet (in millions)

<u>Assets</u>		<u>Liabilities/Equity</u>		
<u>Value</u>	<u>Basis</u>	<u>Value</u>	<u>Basis</u>	
\$5	\$5	Property 1		
\$9	\$9	Property 2		
		\$2	-	\$1.752-7 Liability
				Partner's Equity:
		\$3	\$5	A
		\$3	\$3	B
		\$6	\$6	C

(ii) *Assumption of § 1.752-7 liability by B.* Section 704(c)(1)(B) does not apply to the assumption of the § 1.752-7 liability by B. Instead, A's basis in the PRS interest is reduced (to \$3,000,000) by the § 1.752-7 liability reduction, *i.e.*, the lesser of the excess of A's basis in the PRS interest (\$5,000,000) over the adjusted value (\$3,000,000) of that interest (\$2,000,000), or the remaining built-in loss associated with the § 1.752-7 liability as of the time of the assumption (\$2,000,000). PRS's

basis in Property 2 is reduced (to \$7,000,000) by the \$2,000,000 remaining built-in loss associated with the § 1.752-7 liability. B's basis in Property 1 under section 732(b) is \$3,000,000 (B's basis in the PRS interest). This is \$2,000,000 less than PRS's basis in Property 1 before the distribution of Property 1 to B. If PRS has a section 754 election in effect for 2007, PRS may increase the basis of Property 2 under section 734(b) by \$2,000,000.

§ 1.752-7 Liability Reduction (in millions)

1. Basis of A's PRS interest	\$5
2. Less adjusted value of A's PRS interest	<u>(3)</u>
3. Difference	\$2
4. Remaining built-in loss from § 1.752-7 liability	<u>2</u>
5. § 1.752-7 liability reduction (lesser of 3 or 4)	\$2

A's Basis in PRS after Assumption by B (in millions)

1. Basis before assumption	\$5
2. Less § 1.752-7 liability reduction	<u>(2)</u>
3. Basis after assumption	\$3

PRS's Basis in Property 2 after Assumption by B (in millions)

1. Basis before assumption	\$9
2. Less remaining built-in loss from § 1.752-7 liability	(2)
3. Plus section 734(b) adjustment (if partnership has a section 754 election)	<u>2</u>
4. Basis after assumption	\$9

(iii) *Satisfaction of § 1.752-7 liability.* B is not entitled to a deduction on the satisfaction of the § 1.752-7 liability in 2010 to the extent of

the remaining built-in loss associated with the § 1.752-7 liability (\$2,000,000). As this

amount exceeds the amount paid by B to satisfy the §1.752-7 liability, B is not entitled to any deduction on the satisfaction of the §1.752-7 liability in 2010. B may, however, increase the basis of Property 1 by the lesser of the remaining built-in loss associated with the §1.752-7 liability (\$2,000,000) or the amount paid to satisfy the §1.752-7 liability (\$1,000,000). Therefore, B's basis in Property 1 is increased to \$4,000,000. If B notifies A of the satisfaction of the §1.752-7 liability, then A is entitled to an ordinary deduction in 2010 of \$1,000,000 (the amount paid in satisfaction of the §1.752-7 liability) and a capital loss of \$1,000,000 (the remaining §1.752-7 liability reduction).

B'S BASIS IN PROPERTY 1 AFTER SATISFACTION OF LIABILITY
 [In millions]

1. Basis in Property 1 after distribution	\$3
2. Plus lesser of remaining built-in loss. (\$2) or amount paid to satisfy liability (\$1)	1
3. Basis in Property 1 after satisfaction of liability	\$4

(h) *Notification by the partnership (or successor) of the satisfaction of the §1.752-7 liability.* For purposes of paragraphs (e), (f), and (g) of this section, notification by the partnership (or successor) of the satisfaction of the §1.752-7 liability must be attached to the §1.752-7 liability partner's return (whether an original or an amended return) for the year in which the loss is being claimed and must include—

(1) The amount paid in satisfaction of the §1.752-7 liability, and whether the amounts paid were in partial or complete satisfaction of the §1.752-7 liability;

(2) The name and address of the person satisfying the §1.752-7 liability;

(3) The date of the payment on the §1.752-7 liability; and

(4) The character of the loss to the §1.752-7 liability partner with respect to the §1.752-7 liability.

(i) *Special rule for amounts that are capitalized prior to the occurrence of an event described in paragraphs (e), (f), or*

(g)—(1) *In general.* If all or a portion of a §1.752-7 liability is properly capitalized (capitalized basis) prior to an event described in paragraph (e), (f), or (g) of this section, then, before an event described in paragraph (e), (f), or (g) of this section, the partnership may take the capitalized basis into account for purposes of computing cost recovery and gain or loss on the sale of the asset to which the basis has been capitalized (and for any other purpose for which the basis of the asset is relevant), but after an event described in paragraph (e), (f), or (g) of this section, the partnership may not take any remaining capitalized basis into account for tax purposes.

(2) *Example.* The following example illustrates the provisions of this paragraph (i):

Example. (i) Facts. In 2004, A and B form partnership PRS. A contributes Property 1, a nondepreciable capital asset, with a fair market value and basis of \$5,000,000, in exchange for a 25% interest in PRS and an assumption by PRS of a §1.752-7 liability of \$2,000,000. B contributes \$9,000,000 in cash in exchange for a 75% interest in PRS. PRS uses \$7,000,000 of the cash to purchase Property 2, also a nondepreciable capital asset. In 2007, when PRS's assets have not changed, PRS satisfies the §1.752-7 liability by paying \$2,000,000. Assume that PRS is required to capitalize the cost of satisfying the §1.752-7 liability. In 2008, A sells his interest in PRS to C for \$3,000,000. At the time of the sale, the basis of A's interest is still \$5,000,000.

(ii) *Analysis.* On the sale of A's interest to C, A realizes a loss of \$2,000,000 on the sale of the PRS interest (the excess of \$5,000,000, the basis of the partnership interest, over \$3,000,000, the amount realized on sale). The remaining built-in loss associated with the §1.752-7 liability at that time is zero because all of the §1.752-7 liability as of the time of the assumption of the §1.752-7 liability by the partnership was capitalized by the partnership. The partnership may not take any remaining capitalized basis into account for tax purposes.

Gain/Loss on Sale of A's PRS Interest (in millions)

1.	Amount realized on sale	\$3
2.	Less basis of PRS interest	
	Original Basis	\$5
	§1.752-7 liability reduction	\$0
	Difference	<u>(\$5)</u>
3.	Gain/Loss	<u>(\$2)</u>

(iii) *Partial Satisfaction.* Assume that, prior to the sale of A's interest in PRS to C, PRS had paid \$1,500,000 to satisfy a portion of the §1.752-7 liability. Therefore, immediately before the sale of the PRS interest to C, A's basis in the PRS interest would be reduced (to \$4,500,000) by the \$500,000 remaining built-in loss associated with the §1.752-7 liability (\$2,000,000 less the \$1,500,000 portion capitalized by the partnership as that time). On the sale of the PRS interest, A realizes a loss of \$1,500,000 (the excess of \$4,500,000, the basis of the PRS interest, over \$3,000,000, the amount

realized on the sale). Neither PRS nor any of its partners is entitled to a deduction, loss, or capital expense upon the satisfaction of the §1.752-7 liability to the extent of the remaining built-in loss associated with the §1.752-7 liability (\$500,000). If PRS notifies A of the satisfaction of the remaining portion of the §1.752-7 liability, then A is entitled to a deduction or loss of \$500,000 (the remaining §1.752-7 liability reduction). The partnership may not take any remaining capitalized basis into account for tax purposes.

Gain/Loss on Sale of A's PRS Interest (in millions)

1.	Amount realized on sale	\$3
2.	Less basis of PRS interest	
	Original Basis	\$5
	§1.752-7 liability reduction	<u>(\$0.5)</u>
	Difference	<u>(\$4.5)</u>
3.	Gain/Loss	<u>(\$1.5)</u>

(j) *Tiered partnerships—(1) Look-through treatment.* For purposes of this section, a contribution by a partner of an interest in a partnership (lower-tier partnership) to another partnership (upper-tier partnership) is treated as a contribution by the partner of the lower-tier partnership's assets and an assumption by the upper-tier partnership of the partner's share of the lower-tier partnership's liabilities (including §1.752-7 liabilities). See paragraph (e)(3)(ii) *Example 1* of this section. In addition, a partnership is treated as having its share of any §1.752-7 liabilities of the partnerships in which it has an interest.

(2) *Trade or business exception.* If a partnership (upper-tier partnership) assumes a §1.752-7 liability of a partner,

and, subsequently, another partnership (lower-tier partnership) assumes that §1.752-7 liability from the upper-tier partnership, then the §1.752-7 liability is treated as associated only with any trade or business contributed to the upper-tier partnership by the §1.752-7 liability partner. The same rule applies where a partnership assumes a §1.752-7 liability of a partner, and, subsequently, the §1.752-7 liability partner transfers that partnership interest to another partnership. See paragraph (e)(3)(ii) *Example 1* of this section.

(3) *Partnership as a §1.752-7 liability partner.* If a transaction described in paragraph (e), (f), or (g) of this section occurs with respect to a partnership (upper-tier partnership) that is a §1.752-7 liability partner of another partnership (lower-tier partnership),

then such transaction will also be treated as a transaction described in paragraph (e), (f), or (g) of this section, as appropriate, with respect to the partners of the upper-tier partnership, regardless of whether the upper-tier partnership assumed the §1.752-7 liability from those partners. (See paragraph (b)(5) of this section for rules relating to the treatment of transactions by the partners of the upper-tier partnership). In such a case, each partner's share of the §1.752-7 liability reduction in the upper-tier partnership is equal to that partner's share of the §1.752-7 liability. The partners of the upper-tier partnership at the time of the transaction described in paragraph (e), (f), or (g) of this section, and not the upper-tier partnership, are entitled to the deduction or loss on the satisfaction of the §1.752-7 liability. Similar principles apply where the upper-tier partnership is itself owned by one or a series of partnerships. This paragraph does not apply to the extent that §1.752-7(j)(4) applied to the assumption of the §1.752-7 liability by the lower-tier partnership.

(4) *Transfer of §1.752-7 liability by partnership to another partnership or corporation after a transaction described in paragraph (e), (f), or (g)—(i) In general.* If, after a transaction described in paragraph (e), (f), or (g) of this section with respect to a §1.752-7 liability assumed by a partnership (the upper-tier partnership), another partnership or a corporation assumes the §1.752-7 liability from the upper-tier partnership (or the assuming partner) in a transaction in which the basis of property is determined, in whole or in part, by reference to the basis of the property in the hands of the upper-tier partnership (or assuming partner), then—

(A) The upper-tier partnership (or assuming partner) must reduce its basis in any corporate stock or partnership interest received by the remaining built-in loss associated with the §1.752-7 liability, at the time of the transaction described in paragraph (e), (f), or (g) of this section (but the partners of the upper-tier partnership do not re-

duce their bases or capital accounts in the upper-tier partnership); and

(B) No deduction, loss, or capital expense is allowed to the assuming partnership or corporation on the satisfaction of the §1.752-7 liability to the extent of the remaining built-in loss associated with the §1.752-7 liability.

(ii) *Subsequent transfers.* Similar rules apply to subsequent assumptions of the §1.752-7 liability in transactions in which the basis of property is determined, in whole or in part, by reference to the basis of the property in the hands of the transferor. If, subsequent to an assumption of the §1.752-7 liability by a partnership in a transaction to which paragraph (j)(4)(i) of this section applies, the §1.752-7 liability is assumed from the partnership by a partner other than the partner from whom the partnership assumed the §1.752-7 liability, then the rules of paragraph (g) of this section apply.

(5) *Example.* The following example illustrates the provisions of paragraphs (j)(3) and (4) of this section:

Example. (i) *Assumption of §1.752-7 liability by UTP and transfer of §1.752-7 liability partner's interest in UTP.* In 2004, A, B, and C form partnership UTP. A contributes Property 1 with a fair market value and basis of \$5,000,000 subject to a §1.752-7 liability of \$2,000,000 in exchange for a 25% interest in UTP. B contributes \$3,000,000 cash in exchange for a 25% interest in UTP, and C contributes \$6,000,000 cash in exchange for a 50% interest in UTP. UTP invests the \$9,000,000 cash in Property 2. In 2006, A sells A's interest in UTP to D for \$3,000,000. At the time of the sale, the basis of A's UTP interest is \$5,000,000, the remaining built-in loss associated with the §1.752-7 liability is \$2,000,000, and UTP has no liabilities other than the §1.752-7 liabilities assumed from A. Assume that none of the exceptions of paragraph (d)(2) of this section apply and that the satisfaction of the §1.752-7 liability would give rise to a deductible expense to A and to UTP. Under paragraph (e) of this section, immediately before the sale of the UTP interest to D, A's basis in UTP is reduced to \$3,000,000 by the \$2,000,000 §1.752-7 liability reduction. Therefore, A neither realizes nor recognizes any gain or loss on the sale of the UTP interest to D. D's basis in the UTP interest is \$3,000,000.

UTP Balance Sheet Prior to A's Sale (in millions)

<u>Assets</u>			<u>Liabilities/Equity</u>		
<u>Value</u>	<u>Basis</u>		<u>Value</u>	<u>Basis</u>	
\$5	\$5	Property 1			
\$9	\$9	Property 2			
			\$2		\$1.752-7 Liability
					Partner's Equity:
			\$3	\$5	A (25%)
			\$3	\$3	B (25%)
			\$6	\$6	C (50%)
			<u>\$12</u>	<u>\$14</u>	Total Equity

Gain/Loss on Sale of A's PRS Interest to D (in millions)

1.	Amount realized on sale	\$3
2.	Less basis of PRS interest	
	Original	\$5
	§1.752-7 liability reduction	(\$2)
	Difference	<u>(\$3)</u>
3.	Gain/Loss	\$0

(ii) *Assumption of §1.752-7 liability by LTP from UTP.* In 2008, at a time when the estimated amount of the §1.752-7 liability has increased to \$3,500,000, UTP contributes Property 1 and Property 2, subject to the §1.752-7 liability, to LTP in exchange for a 50% interest in LTP. At the time of the contribution, Property 1 still has a value and basis of \$5,000,000 and Property 2 still has a value and basis of \$9,000,000. UTP's basis in LTP under section 722 is \$14,000,000. Under paragraph (j)(4)(i) of this section, UTP must reduce its basis in LTP by the \$2,000,000 remaining built-in loss associated with the §1.752-7 liability (as of the time of the sale of the UTP interest by A). The partners in UTP are not required to reduce their bases in UTP by this

amount. UTP is a §1.752-7 liability partner of LTP with respect to the entire \$3,500,000 §1.752-7 liability assumed by LTP. However, as A is no longer a partner of UTP, none of the partners of UTP (as of the time of the assumption of the §1.752-7 liability by LTP) are §1.752-7 liability partners of LTP with respect to the \$2,000,000 remaining built-in loss associated with the §1.752-7 liability (as of the time of the sale of the UTP interest by A). The UTP partners (as of the time of the assumption of the §1.752-7 liability by LTP) are §1.752-7 liability partners of LTP with respect to the \$1,500,000 increase in the amount of the §1.752-7 liability of UTP since the assumption of that §1.752-7 liability by UTP from A.

UTP Balance Sheet Immediately Before Contribution to LTP
(in millions)

<u>Assets</u>		<u>Liabilities/Equity</u>		
<u>Value</u>	<u>Basis</u>	<u>Value</u>	<u>Basis</u>	
\$5	\$5			Property 1
\$9	\$9			Property 2
				\$1.752-7 Liability
		\$2		Assumed from A
		\$1.5		Additional
		\$3.5		Total
				Partner's Equity:
		\$2.625	\$3	D (25%)
		\$2.625	\$3	B (25%)
		\$5.25	\$6	C (50%)
		\$10.5	\$12	Total Equity

UTP's Basis in LTP Immediately After Contribution (in millions)

1. Basis in assets	\$14
2. Less remaining built-in loss at time of A's sale	(\$ 2)
3. UTP's basis in LTP	\$12

(iii) *Sale by UTP of LTP interest.* In 2010, UTP sells its interest in LTP to E for \$10,500,000. At the time of the sale, the LTP interest still has a value of \$10,500,000 and a basis of \$12,000,000, and the remaining built-in loss associated with the §1.752-7 liability is \$3,500,000. Under paragraph (e) of this section, immediately before the sale, UTP must reduce its basis in the LTP interest by the §1.752-7 liability reduction. Under paragraph (a)(4) of this section, the remaining built-in loss associated with the §1.752-7 liability is \$1,500,000 (remaining built-in loss associated with the §1.752-7 liability, \$3,500,000, reduced by the amount of the §1.752-7 liability taken into account under paragraph (j)(4) of this

section, \$2,000,000). The difference between the basis of the LTP interest held by UTP (\$12,000,000) and the adjusted value of that interest (\$10,500,000) is also \$1,500,000. Therefore, the §1.752-7 liability reduction is \$1,500,000 and UTP's basis in the LTP interest must be reduced to \$10,500,000. In addition, UTP's partners must reduce their bases in their UTP interests by their proportionate shares of the §1.752-7 liability reduction. Thus, the basis of each of B's and D's interest in UTP must be reduced by \$375,000 and the basis of C's interest in UTP must be reduced by \$750,000. In 2011, D sells the UTP interest to F.

Computation of §1.752-7 Liability Reduction (in millions)

1. Basis of UTP's LTP interest	\$12
2. Less adjusted value of UTP's LTP interest	(\$10.5)
3. Difference between 1 and 2	\$ 1.5
4. Remaining built-in loss from §1.752-7 liability	\$ 1.5
5. §1.752-7 liability reduction (lesser of 3 or 4)	\$ 1.5

Gain/Loss on Sale of UTP's PRS Interest to E (in millions)

1. Amount realized on sale	\$10.5
2. Less basis of PRS interest	
Original	\$12
§1.752-7 liability reduction	(\$ 1.5)
Difference	(\$10.5)
3. Gain/Loss	\$ 0

Partner's Bases in UTP Interests after Sale of LTP Interest (in millions)

	<u>B</u>	<u>C</u>	<u>D</u>
Basis prior to sale	\$3	\$6	\$3
Share of §1.752-7 liability Reduction	(\$0.375)	(\$0.75)	(\$0.375)
Basis after sale	\$2.625	\$5.25	\$2.625

(iv) *Deduction, expense, or loss associated with the §1.752-7 liability by LTP.* In 2012, LTP pays \$3,500,000 to satisfy the §1.752-7 liability. Under paragraphs (e) and (j)(4) of this section, LTP is not entitled to any deduction with respect to the §1.752-7 liability. Under paragraph (j)(3) of this section, UTP also is not entitled to any deduction with respect to the §1.752-7 liability. If LTP notifies A, B, C and D of the satisfaction of the §1.752-7 liability, then A is entitled to a deduction in 2012 of \$2,000,000, B and D are each entitled to deductions in 2012 of \$375,000, and C is entitled to a deduction in 2012 of \$750,000.

(k) *Effective dates—(1) In general.* This section applies to §1.752-7 liability transfers occurring on or after June 24, 2003. For assumptions occurring after October 18, 1999, and before June 24, 2003, see §1.752-6. For §1.752-7 liability transfers occurring on or after June 24, 2003 and before May 26, 2005, taxpayers may rely on the exception for trading and investment partnerships in paragraph (b)(8)(ii) of §1.752.7 (2003-28 I.R.B. 46; 68 FR 37434).

(2) *Election to apply this section to assumptions of liabilities occurring after October 18, 1999 and before June 24, 2003—(i) In general.* A partnership may elect to apply this section to all assumptions of

liabilities (including §1.752-7 liabilities) occurring after October 18, 1999, and before June 24, 2003. Such an election is binding on the partnership and all of its partners. A partnership making such an election must apply all of the provisions of §1.752-1 and §1.752-7, including §1.358-5T, §1.358-7, §1.704-1(b)(1)(ii) and (b)(2)(iv)(b), §1.704-2(b)(3), §1.704-3(a)(7), (a)(8)(iv), and (a)(12), §1.704-4(d)(1)(iv), §1.705-1(a)(8), §1.732-2(d)(3)(iv), and §1.737-5.

(ii) *Manner of making election.* A partnership makes an election under this paragraph (k)(2) by attaching the following statement to its timely filed return: [Insert name and employer identification number of electing partnership] elects under §1.752-7 of the Income Tax Regulations to be subject to the rules of §1.358-5T, §1.358-7, §1.704-1(b)(1)(ii) and (b)(2)(iv)(b), §1.704-2(b)(3), §1.704-3(a)(7), (a)(8)(iv), and (a)(12), §1.704-4(d)(1)(iv), §1.705-1(a)(8), §1.732-2(d)(3)(iv), and §1.737-5 with respect to all liabilities (including §1.752-7 liabilities) assumed by the partnership after October 18, 1999 and before June 24, 2003. In the statement, the partnership must list, with respect to each liability

(including each §1.752-7 liability) assumed by the partnership after October 18, 1999 and before June 24, 2003—

(A) The name, address, and taxpayer identification number of the partner from whom the liability was assumed;

(B) The date on which the liability was assumed by the partnership;

(C) The amount of the liability as of the time of its assumption; and

(D) A description of the liability.

(iii) *Filing of amended returns.* An election under this paragraph (k)(2) will be valid only if the partnership and its partners promptly amend any returns for open taxable years that would be affected by the election.

(iv) *Time for making election.* An election under this paragraph (k)(2) must be filed with any timely filed Federal income tax return filed by the partnership on or after September 24, 2003 and on or before December 31, 2005.

[T.D. 9207, 70 FR 30344, May 26, 2005; 70 FR 39654, July 11, 2005]

§ 1.753-1 Partner receiving income in respect of decedent.

(a) *Income in respect of a decedent under section 736(a).* All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

(b) *Other income in respect of a decedent.* When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is

not included in the value of the decedent's partnership interest for estate tax purposes. See paragraph (c) (3) of §1.706-1.

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. A and the decedent B were equal partners in a business having assets (other than money) worth \$40,000 with an adjusted basis of \$10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of \$10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus \$10,000 in each of the three years after death. B's share of earnings to the date of his death was \$4,000, of which he had withdrawn \$3,000. B's distributive share of partnership income of \$4,000 to the date of his death is income in respect of a decedent (although only the \$1,000 undrawn at B's death will be reflected in the value of B's partnership interest on B's estate tax return). Assume that the value of B's interest in partnership property at the date of his death was \$22,000, composed of the following items: B's one-half share of the assets of \$40,000, plus \$2,000, B's interest in partnership cash. It should be noted that B's \$1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partnership assets. Under the partnership agreement, A is to pay B's estate a total of \$31,000. The difference of \$9,000 between the amount to be paid by A (\$31,000) and the value of B's interest in partnership property (\$22,000) comes within section 736(a) and, thus, also constitutes income in respect of a decedent. (However, the \$17,000 difference between the \$5,000 basis for B's share of the partnership property and its \$22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B's estate \$11,000, of which they agree to allocate \$3,000 as the payment under section 736(a), B's estate will include \$7,000 in its gross income (B's \$4,000 distributive share plus \$3,000 payment under section 736(a)). In computing the deduction under section 691(c), this \$7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only \$4,000 (\$1,000 of distributive share not withdrawn, plus \$3,000, payment under section 736(a)) of this amount can be identified on

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the estate tax return as part of the partnership interest.

(d) *Effective date.* The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and paragraph (b)(4) of § 1.771-1.

§ 1.754-1 Time and manner of making election to adjust basis of partnership property.

(a) *In general.* A partnership may adjust the basis of partnership property under sections 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) *Time and method of making election.* (1) An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of § 1.6031-1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). Notwithstanding the preceding two sentences, if a valid election has been made under section 754 and this section for a preceding taxable year and not revoked pursuant to paragraph (c) of this section, a new election is not required to be made. The statement required by this subparagraph shall (i) set forth the name and address of the partnership making the election, (ii) be signed by any one of the partners, and (iii) con-

tain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). For rules regarding extensions of time for filing elections, see § 1.9100-1.

(2) The principles of this paragraph may be illustrated by the following example:

Example. A, a U.S. citizen, is a member of partnership ABC, which has not previously made an election under section 754 to adjust the basis of partnership property. The partnership and the partners use the calendar year as the taxable year. A sells his interest in the partnership to D on January 1, 1971. The partnership may elect under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b). Unless an extension of time to make the election is obtained under the provisions of § 1.9100-1, the election must be made in a written statement filed with the partnership return for 1971 and must contain the information specified in subparagraph (1) of this paragraph. Such return must be filed by April 17, 1972 (unless an extension of time for filing the return is obtained). The election will apply to all distributions of property to a partner and transfers of an interest in the partnership occurring in 1971 and subsequent years, unless revoked pursuant to paragraph (c) of this section.

(c) *Revocation of election—(1) In general.* A partnership having an election in effect under this section may revoke such election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the internal revenue district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership

interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

(2) *Revocations effective on December 15, 1999.* Notwithstanding paragraph (c)(1) of this section, any partnership having an election in effect under this section for its taxable year that includes December 15, 1999, may revoke such election effective for transfers or distributions occurring on or after December 15, 1999, by attaching a statement to the partnership's return for such year. For the revocation to be valid, the statement must be filed not later than the time prescribed by § 1.6031(a)-1(e) (including extensions thereof) for filing the return for such taxable year, and must set forth the name and address of the partnership revoking the election, be signed by any one of the partners who is authorized to sign the partnership's federal income tax return, and contain a declaration that the partnership revokes its election under section 754 to apply the provisions of section 734(b) and 743(b). In addition, the following statement must be prominently displayed in capital letters on the first page of the partnership's return for such year: "RETURN FILED PURSUANT TO § 1.754-1(c)(2)."

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972; T.D. 8847, 64 FR 69916, Dec. 15, 1999; 65 FR 9220, Feb. 24, 2000]

§ 1.755-1 Rules for allocation of basis.

(a) *In general*—(1) *Scope.* This section provides rules for allocating basis adjustments under sections 743(b) and 734(b) among partnership property. If there is a basis adjustment to which this section applies, the basis adjustment is allocated among the partnership's assets as follows. First, the partnership must determine the value of each of its assets under paragraphs (a)(2) through (5) of this section. Second, the basis adjustment is allocated between the two classes of property described in section 755(b). These classes

of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class. Basis adjustments under section 743(b) are allocated among partnership assets under paragraph (b) of this section. Basis adjustments under section 734(b) are allocated among partnership assets under paragraph (c) of this section.

(2) *Coordination of sections 755 and 1060.* If there is a basis adjustment to which this section applies, and the assets of the partnership constitute a trade or business (as described in § 1.1060-1(b)(2)), then the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles. To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term *section 197 intangibles* includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

(3) *Values of properties other than section 197 intangibles.* For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

(4) *Partnership gross value*—(i) *Basis adjustments under section 743(b)*—(A) *In general.* Except as provided in paragraph (a)(4)(ii) of this section, in the case of a basis adjustment under section 743(b), partnership gross value generally is equal to the amount that,

if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).

(B) *Special situations.* In certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles held by the partnership. In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

(C) *Income in respect of a decedent.* Solely for the purpose of determining partnership gross value under this paragraph (a)(4)(i), where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to section 1014(c), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691.

(ii) *Basis adjustments under section 743(b) resulting from substituted basis transactions.* This paragraph (a)(4)(ii) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to

the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

(iii) *Basis adjustments under section 734(b).* In the case of a basis adjustment under section 734(b), partnership gross value equals the value of the entire partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution.

(5) *Determining the values of section 197 intangibles—(i) Two classes.* If the aggregate value of partnership property other than section 197 intangibles (as determined in paragraph (a)(3) of this section) is equal to or greater than partnership gross value (as determined in paragraph (a)(4) of this section), then all section 197 intangibles are deemed to have a value of zero for purposes of this section. In all other cases, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles. The residual section 197 intangibles value must be allocated between two asset classes in the following order—

(A) Among section 197 intangibles other than goodwill and going concern value; and

(B) To goodwill and going concern value.

(ii) *Values assigned to section 197 intangibles other than goodwill and going concern value.* The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going

concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

(iii) *Value assigned to goodwill and going concern value.* The fair market value of goodwill and going concern value is the amount, if any, by which the residual section 197 intangibles value exceeds the aggregate value of the partnership's section 197 intangibles (other than goodwill and going concern value).

(6) *Examples.* The provisions of paragraphs (a)(2) through (5) are illustrated by the following examples, which assume that the partnerships have an election in effect under section 754 at the time of the transfer and that the assets of each partnership constitute a trade or business (as described in § 1.1060-1(b)(2)). Except as provided, no partnership asset (other than inventory) is property described in section

751(a), and partnership liabilities are secured by all partnership assets. The examples are as follows:

Example 1. (i) A is the sole general partner in PRS, a limited partnership having three equal partners. PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two other assets with fair market values (determined using all the facts and circumstances) as follows: inventory worth \$1,000,000 and a building (a capital asset) worth \$2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is \$50,000. PRS has one liability of \$1,000,000, for which A bears the entire risk of loss under section 752 and the regulations thereunder. D purchases A's partnership interest for \$650,000, resulting in a basis adjustment under section 743(b). After the purchase, D bears the entire risk of loss for PRS's liability under section 752 and the regulations thereunder. Therefore, D's basis in its interest in PRS is \$1,650,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is \$650,000 (\$1,650,000—\$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is \$2,950,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to \$650,000).

(iii) Under paragraph (a)(3) of this section, the inventory has a fair market value of \$1,000,000, and the building has a fair market value of \$2,000,000. Thus, the aggregate value of partnership property other than section 197 intangibles, \$3,000,000, is equal to or greater than partnership gross value, \$2,950,000. Accordingly, under paragraphs (a)(3) and (5) of this section, the value assigned to each of the partnership's assets is as follows: inventory, \$1,000,000; building, \$2,000,000; Intangibles 1 and 2, \$0; and goodwill and going concern value, \$0. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 2. (i) Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each \$300,000, and that D purchases A's interest in PRS for \$1,000,000. After the purchase, D's basis in its interest in PRS is \$2,000,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is \$1,000,000 (\$2,000,000—\$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is \$4,000,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to \$1,000,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is

\$1,000,000 (the excess of partnership gross value, \$4,000,000, over the aggregate value of assets other than section 197 intangibles, \$3,000,000 (the sum of the value of the inventory, \$1,000,000, and the value of the building, \$2,000,000)). The partnership must determine the values of section 197 assets by allocating the residual section 197 intangibles value among the partnership's assets. The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, \$300,000 is assigned to each of Intangible 1 and Intangible 2, and \$400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, \$1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, \$600,000). D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 3. (i) Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each \$300,000, and that D purchases A's interest in PRS for \$750,000. After the purchase, D's basis in its interest in PRS is \$1,750,000. Also assume that Intangible 1 was originally purchased for \$300,000, and that its adjusted basis has been decreased to \$50,000 as a result of amortization. Assume that, if PRS were to sell Intangible 1 for \$300,000, it would recognize \$250,000 of gain that would be treated as an unrealized receivable under the flush language in section 751(c).

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is \$750,000 (\$1,750,000—\$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is \$3,250,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to \$750,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is \$250,000 (the amount by which partnership gross value, \$3,250,000, exceeds the aggregate value of partnership property other than section 197 intangibles, \$3,000,000). Intangible 1 has potential gain that would be treated as unrealized receivables under the flush language of section 751(c). The flush language receivables value in Intangible 1 is \$300,000 (the sum of PRS's basis in Intangible 1, \$50,000, and the amount of ordinary income, \$250,000, that the partnership would recognize if Intangible 1 were sold for its actual fair market value). Because the residual section 197 intangibles value, \$250,000, is less than the flush language receivables value of Intangible 1, Intangible 1 is assigned a value of \$250,000, and Intangible 2 and goodwill and going concern value are assigned a value of zero. D's section 743(b) adjustment must be

allocated under paragraph (b) of this section using these assigned fair market values.

Example 4. Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each \$300,000, and that A does not sell its interest in PRS. Instead, A contributes its interest in PRS to E, a newly formed corporation wholly-owned by A, in a transaction described in section 351. Assume that the contribution results in a basis adjustment under section 743(b) (other than zero). PRS determines that its value as a going concern immediately following the contribution is \$3,000,000. Under paragraph (a)(4)(ii) of this section, partnership gross value is \$4,000,000 (the value of PRS as a going concern, \$3,000,000, increased by the partnership's liability, \$1,000,000, immediately after the contribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value is \$1,000,000 (the amount by which partnership gross value, \$4,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, \$3,000,000). Of the residual section 197 intangibles value, \$300,000 is assigned to each of Intangible 1 and Intangible 2, and \$400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, \$1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, \$600,000). E's section 743(b) adjustment must be allocated under paragraph (b)(5) of this section using these assigned fair market values.

Example 5. G is the sole general partner in PRS, a limited partnership having three equal partners (G, H, and I). PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two capital assets with fair market values (determined using all the facts and circumstances) as follows: Vacant land worth \$1,000,000, and a building worth \$2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is \$300,000. PRS has one liability of \$1,000,000, for which G bears the entire risk of loss under section 752 and the regulations thereunder. PRS distributes the land to H in liquidation of H's interest in PRS. Immediately prior to the distribution, PRS's basis in the land is \$800,000, and H's basis in its interest in PRS is \$750,000. The distribution causes the partnership to increase the basis of its remaining property by \$50,000 under section 734(b)(1)(B). PRS determines that its value as a going concern immediately following the distribution is \$2,000,000. Under paragraph (a)(4)(iii) of this section, partnership gross value is \$3,000,000 (the value of PRS as a going concern, \$2,000,000, increased by the partnership's liability, \$1,000,000, immediately after the distribution). Under paragraph (a)(5) of this section, the residual

section 197 intangibles value of PRS's section 197 intangibles is \$1,000,000 (the amount by which partnership gross value, \$3,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, \$2,000,000). Of the residual section 197 intangibles value, \$300,000 is assigned to each of Intangible 1 and Intangible 2, and \$400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, \$1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, \$600,000). PRS's section 734(b) adjustment must be allocated under paragraph (c) of this section using these assigned fair market values.

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

(1) *Generally.* (i) *Application.* For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

(ii) *Hypothetical transaction.* For purposes of paragraphs (b)(2) through (b)(4) of this section, the allocation of the basis adjustment under section 743(b) between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss (including remedial allocations under §1.704-3(d)) that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction). See §1.460-4(k)(3)(v)(B) for

a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

(2) *Allocations between classes of property*—(i) *In general.* The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction. The amount of the basis adjustment to capital gain property is equal to—

(A) The total amount of the basis adjustment under section 743(b); less

(B) The amount of the basis adjustment allocated to ordinary income property under the preceding sentence; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under §1.704-3(d) from the hypothetical transaction) in capital gain property. In the event that a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.

(ii) *Examples.* The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1. (i) A and B form equal partnership PRS. A contributes \$50,000 and Asset 1, a nondepreciable capital asset with a fair market value of \$50,000 and an adjusted tax basis of \$25,000. B contributes \$100,000. PRS uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for \$120,000. At the time of the transfer, A's share of the partnership's basis in partnership assets is \$75,000. Therefore, T receives a \$45,000 basis adjustment.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

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	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1	\$25,000	\$75,000
Asset 2	100,000	117,500
Ordinary Income Property:		
Asset 3	40,000	45,000
Asset 4	10,000	2,500
Total	175,000	240,000

(iii) If PRS sold all of its assets in a fully taxable transaction at fair market value immediately after the transfer of the partnership interest to T, the total amount of capital gain that would be allocated to T is equal to \$46,250 (\$25,000 section 704(c) built-in gain from Asset 1, plus fifty percent of the \$42,500 appreciation in capital gain property). T would also be allocated a \$1,250 ordinary loss from the sale of the ordinary income property.

(iv) The amount of the basis adjustment that is allocated to ordinary income property is equal to (\$1,250) (the amount of the loss allocated to T from the hypothetical sale of the ordinary income property).

(v) The amount of the basis adjustment that is allocated to capital gain property is equal to \$46,250 (the amount of the basis adjustment, \$45,000, less (\$1,250), the amount of loss allocated to T from the hypothetical sale of the ordinary income property).

Example 2. (i) A and B form equal partnership PRS. A and B each contribute \$1,000 cash which the partnership uses to purchase Assets 1, 2, 3, and 4. After a year, A sells its partnership interest to T for \$1,000. T's basis adjustment under section 743(b) is zero.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1	\$500	\$750
Asset 2	500	500
Ordinary Income Property:		
Asset 3	500	250
Asset 4	500	500
Total	2,000	2,000

(iii) If, immediately after the transfer of the partnership interest to T, PRS sold all of its assets in a fully taxable transaction at fair market value, T would be allocated a loss of \$125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is (\$125). The amount of the basis adjustment to capital gain property is \$125 (zero, the amount of the basis adjustment

under section 743(b), less (\$125), the amount of the basis adjustment allocated to ordinary income property).

(3) *Allocation within the class*—(i) *Ordinary income property.* The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; reduced by

(B) The product of—

(1) Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to the last sentence of paragraph (b)(2)(i) of this section; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

(ii) *Capital gain property.* The amount of the basis adjustment to each item of property within the class of capital gain property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; minus

(B) The product of—

(1) The total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

(iii) *Special rules*—(A) *Assets in which partner has no interest.* An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in applying paragraph (b)(3)(ii)(B) of this section.

(B) *Limitation in decrease of basis.* In no event may the amount of any decrease in basis allocated to an item of capital gain property under paragraph (b)(3)(ii)(B) of this section exceed the partnership's adjusted basis in that item (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under § 1.704-3(d) from the hypothetical transaction). In the event that a decrease in basis allocated under paragraph (b)(3)(ii)(B) of this section to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under this paragraph (b)(3)).

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

Example 1. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section. Of the \$45,000 basis adjustment, \$46,250 was allocated to capital gain property. The amount allocated to ordinary income property was (\$1,250).

(ii) Asset 1 is a capital gain asset, and T would be allocated \$37,500 from the sale of Asset 1 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 1 is \$37,500.

(iii) Asset 2 is a capital gain asset, and T would be allocated \$8,750 from the sale of Asset 2 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 2 is \$8,750.

(iv) Asset 3 is ordinary income property, and T would be allocated \$2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is \$2,500.

(v) Asset 4 is ordinary income property, and T would be allocated (\$3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is (\$3,750).

Example 2. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section, except that A sold its interest in PRS to T for \$110,000 rather than \$120,000. T, therefore, receives a basis adjustment under section

743(b) of \$35,000. Of the \$35,000 basis adjustment, (\$1,250) is allocated to ordinary income property, and \$36,250 is allocated to capital gain property.

(ii) Asset 3 is ordinary income property, and T would be allocated \$2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is \$2,500.

(iii) Asset 4 is ordinary income property, and T would be allocated (\$3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is (\$3,750).

(iv) Asset 1 is a capital gain asset, and T would be allocated \$37,500 from the sale of Asset 1 in the hypothetical transaction. Asset 2 is a capital gain asset, and T would be allocated \$8,750 from the sale of Asset 2 in the hypothetical transaction. The total amount of gain that would be allocated to T from the sale of the capital gain assets in the hypothetical transaction is \$46,250, which exceeds the amount of the basis adjustment allocated to capital gain property by \$10,000. The amount of the adjustment to Asset 1 is \$33,604 (\$37,500 minus \$3,896 (\$10,000×\$75,000/\$192,500)). The amount of the basis adjustment to Asset 2 is \$2,646 (\$8,750 minus \$6,104 (\$10,000×\$117,500/\$192,500)).

(4) *Income in respect of a decedent*—(i) *In general.* Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. See § 1.742-1. Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets. See § 1.743-1(b).

(ii) The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) A and B are equal partners in personal service partnership PRS. In 2004, as a result of B's death, B's partnership interest is transferred to T when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows (based on all the facts and circumstances):

ASSETS		
	Adjusted basis	Fair market value
Section 197 Intangible	\$2,000	\$5,000
Unrealized Receivables	0	15,000
Total	\$2,000	\$20,000
Liabilities and Capital		
	Adjusted per books	Fair market value
Capital:		
A	1,000	10,000
B	1,000	10,000
Total	\$2,000	\$20,000

(ii) None of the assets owned by PRS is section 704(c) property, and the section 197 intangible is not amortizable. The fair market value of T's partnership interest on the applicable date of valuation set forth in section 1014 is \$10,000. Of this amount, \$2,500 is attributable to T's 50% share of the partnership's section 197 intangible, and \$7,500 is attributable to T's 50% share of the partnership's unrealized receivables. The partnership's unrealized receivables represent income in respect of a decedent. Accordingly, under section 1014(c), T's basis in its partnership interest is not adjusted for that portion of the interest which is attributable to the unrealized receivables. Therefore, T's basis in its partnership interest is \$2,500.

(iii) Under paragraph (a)(4)(i)(C) of this section, solely for purposes of determining partnership gross value, T's basis in its partnership interest is deemed to be \$10,000. Under paragraph (a)(4)(i) of this section, partnership gross value is \$20,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to T equal to \$10,000).

(iv) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is \$5,000 (the excess of partnership gross value, \$20,000, over the aggregate value of assets other than section 197 intangibles, \$15,000). The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, \$5,000 is assigned to the section 197 intangible, and \$0 is assigned to goodwill and going concern value. T's section 743(b) adjustment must be allocated using these assigned fair market values.

(v) At the time of the transfer, B's share of the partnership's basis in partnership assets is \$1,000. Accordingly, T receives a \$1,500 basis adjustment under section 743(b). Under this paragraph (b)(4), the entire basis adjustment is allocated to the partnership's section 197 intangible.

(5) *Substituted basis transactions*—(i) *In general.* This paragraph (b)(5) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest. For exchanges on or after June 9, 2003, this paragraph (b)(5) also applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. For example, this paragraph (b)(5) applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies, if a partnership interest is contributed to a partnership in a transaction to which section 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which section 731(a) applies.

(ii) *Allocations between classes of property.* If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5). If there is an increase in basis to be allocated to partnership assets, such increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. Where, under the preceding sentence, an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase shall be allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class. If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be

allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Where, under the preceding sentence, a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss which would be allocated to the transferee from the sale of all assets in each class.

(iii) *Allocations within the classes—(A) Increases.* If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

(B) *Decreases.* If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

(C) *Limitation in decrease of basis.* Where, as the result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's ad-

justed basis in all depreciated assets in that class.

(D) *Carryover adjustment.* Where a transferee's negative basis adjustment under section 743(b) cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(iv) *Examples.* The provisions of this paragraph (b)(5) are illustrated by the following examples:

Example 1. A is a member of partnership LTP, which has made an election under section 754. The three partners in LTP have equal interests in capital and profits. Solely in exchange for a partnership interest in UTP, A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its partnership interest (\$5,000) equals its share of inside basis (also \$5,000). Under section 723, UTP's basis in its interest in LTP is \$5,000. LTP's only two assets on the date of contribution are inventory with a basis of \$5,000 and a fair market value of \$7,500, and a nondepreciable capital asset with a basis of \$10,000 and a fair market value of \$7,500. The amount of the basis adjustment under section 743(b) to partnership property is \$0 (\$5,000, UTP's basis in its interest in LTP, minus \$5,000, UTP's share of LTP's basis in partnership assets). Because UTP acquired its interest in LTP in a substituted basis transaction, and the total amount of the basis adjustment under section 743(b) is zero, UTP receives no special basis adjustments under section 743(b) with respect to the partnership property of LTP.

Example 2. (i) A purchases a partnership interest in LTP at a time when an election under section 754 is not in effect. The three partners in LTP have equal interests in capital and profits. During a later year for which LTP has an election under section 754 in effect, and in a transaction that is unrelated to A's purchase of the LTP interest, A contributes its interest in LTP to UTP in a transaction described in section 721 (solely in exchange for a partnership interest in UTP). At the time of the transfer, A's adjusted basis in its interest in LTP is \$20,433. Under section 721, A recognizes no gain or loss as a result of the contribution of its partnership interest to UTP. Under section 723, UTP's basis in its partnership interest in LTP is \$20,433. The balance sheet of LTP on the date of the contribution shows the following:

	Assets	
	Adjusted basis	Fair market value
Cash	\$5,000	\$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Nondepreciable capital asset	20,000	40,000
Total	55,000	76,000

	Liabilities and Capital	
	Adjusted per books	Fair market value
Liabilities	\$10,000	\$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of UTP's interest in LTP and UTP's share of the adjusted basis to LTP of partnership property. UTP's interest in the previously taxed capital of LTP is \$15,000 (\$22,000, the amount of cash UTP would receive if LTP liquidated immediately after the hypothetical transaction, decreased by \$7,000, the amount of tax gain allocated to UTP from the hypothetical transaction). UTP's share of the adjusted basis to LTP of partnership property is \$18,333 (\$15,000 share of previously taxed capital, plus \$3,333 share of LTP's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is \$2,100 (\$20,433 minus \$18,333).

(iii) The total amount of gain that would be allocated to UTP from the hypothetical sale of capital gain property is \$6,666.67 (one-third of the excess of the fair market value of LTP's nondepreciable capital asset, \$40,000, over its basis, \$20,000). The total amount of gain that would be allocated to UTP from the hypothetical sale of ordinary income property is \$333.33 (one-third of the excess of the fair market value of LTP's inventory, \$21,000, over its basis, \$20,000). Under this paragraph (b)(5), LTP must allocate \$2,000 (\$6,666.67 divided by \$7,000 times \$2,100) of UTP's basis adjustment to the nondepreciable capital asset. LTP must allocate \$100 (\$333.33 divided by \$7,000 times \$2,100) of UTP's basis adjustment to the inventory.

(c) *Adjustments under section 734(b)*—(1) *Allocations between classes of property*—(i) *General rule.* Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to

remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

(ii) *Special rule.* Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.

(2) *Allocations within the classes*—(i) *Increases.* If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

(ii) *Decreases.* If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective

amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).

(3) *Limitation in decrease of basis.* Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property is reduced to zero (but not below zero).

(4) *Carryover adjustment.* Where, in the case of a distribution, an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(5) *Cross reference.* See §1.460-4(k)(3)(v)(B) for a rule relating to the computation of unrealized appreciation or depreciation in a contract accounted for under a long-term contract method of accounting.

(6) *Example.* The following example illustrates this paragraph (c):

Example. (i) A, B, and C form equal partnership PRS. A contributes \$50,000 and Asset 1, nondepreciable capital gain property with a fair market value of \$50,000 and an adjusted tax basis of \$25,000. B and C each contributes \$100,000. PRS uses the cash to purchase Assets 2, 3, 4, 5, and 6. Assets 2 and 3 are nondepreciable capital assets, and Assets 4, 5, and 6 are inventory that has not appreciated substantially in value within the meaning of section 751(b)(3). Assets 4, 5, and 6 are the only assets held by the partnership that are subject to section 751. The partnership has an election in effect under section 754. After seven years, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1	\$ 25,000	\$ 75,000
Asset 2	100,000	117,500
Asset 3	50,000	60,000
Ordinary Income Property:		
Asset 4	40,000	45,000

	Assets	
	Adjusted basis	Fair market value
Asset 5	50,000	60,000
Asset 6	10,000	2,500
Total	275,000	360,000

(ii) *Allocation between classes.* Assume that PRS distributes Assets 3 and 5 to A in complete liquidation of A's interest in the partnership. A's basis in the partnership interest was \$75,000. The partnership's basis in Assets 3 and 5 was \$50,000 each. A's \$75,000 basis in its partnership interest is allocated between Assets 3 and 5 under sections 732(b) and (c). A will, therefore, have a basis of \$25,000 in Asset 3 (capital gain property), and a basis of \$50,000 in Asset 5 (section 751 property). The distribution results in a \$25,000 increase in the basis of capital gain property. There is no change in the basis of ordinary income property.

(iii) *Allocation within class.* The amount of the basis increase to capital gain property is \$25,000 and must be allocated among the remaining capital gain assets in proportion to the difference between the fair market value and basis of each. The fair market value of Asset 1 exceeds its basis by \$50,000. The fair market value of Asset 2 exceeds its basis by \$17,500. Therefore, the basis of Asset 1 will be increased by \$18,519 (\$25,000, multiplied by \$50,000, divided by \$67,500), and the basis of Asset 2 will be increased by \$6,481 (\$25,000 multiplied by \$17,500, divided by \$67,500).

(d) *Required statements.* See §1.743-1(k)(2) for provisions requiring the transferee of a partnership interest to provide information to the partnership relating to the transfer of an interest in the partnership. See §1.743-1(k)(1) for a provision requiring the partnership to attach a statement to the partnership return showing the computation of a basis adjustment under section 743(b) and the partnership properties to which the adjustment is allocated under section 755. See §1.732-1(d)(3) for a provision requiring a transferee partner to attach a statement to its return showing the computation of a basis adjustment under section 732(d) and the partnership properties to which the adjustment is allocated under section 755. See §1.732-1(d)(5) for a provision requiring the partnership to provide information to a transferee partner reporting a basis adjustment under section 732(d).

(e) *Effective Date—(1) Generally.* Except as provided in paragraphs (b)(5) and (e)(2) of this section, this section

applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

(2) *Special rules.* Paragraphs (a) and (b)(3)(iii) of this section apply to transfers of partnership interests and distributions of property from a partnership that occur on or after June 9, 2003.

[T.D. 8847, 64 FR 69916, Dec. 15, 1999; 65 FR 9220, Feb. 24, 2000, as amended by T.D. 9059, 68 FR 34295, June 9, 2003; T.D. 9137, 69 FR 42559, July 16, 2004]

DEFINITIONS

§ 1.761-1 Terms defined.

(a) *Partnership.* The term *partnership* means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

(b) *Partner.* The term *partner* means a member of a partnership.

(c) *Partnership agreement.* For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) *Liquidation of partner's interest.* The term *liquidation of a partner's interest* means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or

in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of § 1.731-1.

(e) *Distribution of partnership interest.* For purposes of section 708(b)(1)(B) and § 1.708-1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. However, the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of section 743. This paragraph (e) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (e) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (e) to the termination in a consistent manner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972; T.D. 8697, 61 FR 66588, Dec. 18, 1996; T.D. 8717, 62 FR 25501, May 9, 1997]

§ 1.761-2 Exclusion of certain unincorporated organizations from the application of all or part of subchapter K of chapter 1 of the Internal Revenue Code.

(a) *Exclusion of eligible unincorporated organizations—(1) In general.* Under conditions set forth in this section, an unincorporated organization described in subparagraph (2) or (3) of this paragraph may be excluded from the application of all or a part of the provisions of subchapter K of chapter 1 of the Code. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be