in minimum gain with respect to that liability.

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§ 1.704–3 Contributed property.

(a) *In general*—(1) *General principles.* The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (e.g., aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704–3(d). Paragraph (e) of this section contains special rules and exceptions.

(2) *Operating rules.* Except as provided in paragraphs (e)(2) and (e)(3) of this section, section 704(c) and this section apply on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated. A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of section 704(c). It may be unreasonable to use one method for appreciated property and another method for depreciated property. Similarly, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate. A new partnership formed as the result of the termination of a partnership under section 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to section 704(c) property deemed contributed to the new partnership by the terminated partnership under § 1.708–1(b)(1)(iv). The previous sentence applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentence may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentence to the termination in a consistent manner.

(3) *Definitions*—(i) *Section 704(c) property.* Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis. For purposes of this section, book value is determined as contemplated by § 1.704–1(b). Therefore, book value is equal to fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property. For a partnership that maintains capital accounts in accordance with § 1.704–1(b)(2)(iv), the book value of property is initially the value used in determining the contributing partner's capital account under § 1.704–1(b)(2)(iv)(*d*), and is appropriately adjusted thereafter (e.g., for book cost recovery under §§ 1.704–1(b)(2)(iv)(*g*)(*3*) and

1.704–3(d)(2) and other events that affect the basis of the property). A partnership that does not maintain capital accounts under § 1.704–1(b)(2)(iv) must comply with this section using a book capital account based on the same principles (i.e., a book capital account that reflects the fair market value of property at the time of contribution and that is subsequently adjusted for cost recovery and other events that affect the basis of the property). Property deemed contributed to a new partnership as the result of the termination of a partnership under section 708(b)(1)(B) is treated as section 704(c) property in the hands of the new partnership only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination. See § 1.708–1(b)(1)(iv) for an example of the application of this rule. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(ii) *Built-in gain and built-in loss.* The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis. The built-in loss on section 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted tax basis and book value.

(4) *Accounts payable and other accrued but unpaid items.* Accounts payable and other accrued but unpaid items contributed by a partner using the cash receipts and disbursements method of accounting are treated as section 704(c) property for purposes of applying the rules of this section.

(5) *Other provisions of the Internal Revenue Code.* Section 704(c) and this section apply to a contribution of property to the partnership only if the contribution is governed by section 721, taking into account other provisions of the Internal Revenue Code. For example, to the extent that a transfer of property to a partnership is a sale under section 707, the transfer is not a contribution of property to which section 704(c) applies.

(6) *Other applications of section 704(c) principles*—(i) *Revaluations under section 704(b).* The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704–1(b)(2)(iv)(*f*) (reverse section 704(c) allocations). Partnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c) and paragraph (a) of this section. In addition, partnerships are not required to use the same allocation method for reverse section 704(c) allocations each time the partnership revalues its property. A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of section 704(b) and (c).

(ii) *Basis adjustments.* A partnership making adjustments under § 1.743–1(b) or 1.751–1(a)(2) must account for built-in gain or loss under section 704(c) in accordance with the principles of this section.

(7) *Transfers of a partnership interest.* If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.

(8) *Disposition of property in nonrecognition transaction.* If a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the

same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership.

(9) *Tiered partnerships.* If a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Allocations made under this paragraph will be considered to be made in a manner that meets the requirements of §1.704–1(b)(2)(iv)(*q*) (relating to capital account adjustments where guidance is lacking).

(10) *Anti-abuse rule.* An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

(11) *Contributing and noncontributing partners' recapture shares.* For special rules applicable to the allocation of depreciation recapture with respect to property contributed by a partner to a partnership, see §§1.1245–1(e)(2) and 1.1250–1(f).

(b) *Traditional method*—(1) *In general.* This paragraph (b) describes the traditional method of making section 704(c) allocations. In general, the traditional method requires that when the partnership has income, gain, loss, or deduction attributable to section 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the partnership sells section 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner. If the partnership sells a portion of, or an interest in, section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner. For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners. However, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule). If a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

(2) *Examples.* The following examples illustrate the principles of the traditional method.

Example 1. Operation of the traditional method—(i) *Calculation of built-in gain on contribution*. A and B form partnership AB and agree that each will be allocated a 50 percent share of all partnership items and that AB will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. A contributes depreciable property with an adjusted tax basis of $4,000 and a book value of $10,000, and B contributes $10,000 cash. Under paragraph (a)(3) of this section, A has built-in gain of $6,000, the excess of the partnership's book value for the property ($10,000) over A's adjusted tax basis in the property at the time of contribution ($4,000).

(ii) *Allocation of tax depreciation.* The property is depreciated using the straight-line method over a 10-year recovery period. Because the property depreciates at an annual rate of 10 percent, B would have been entitled to a depreciation deduction of $500 per year for both book and tax purposes if the adjusted tax basis of the property equalled its fair market value at the time of contribution. Although each partner is allocated $500 of book depreciation per year, the partnership is allowed a tax depreciation deduction of only $400 per year (10 percent of $4,000). The partnership can allocate only $400 of tax depreciation under the ceiling rule of paragraph (b)(1) of this section, and it must be allocated entirely to B. In AB's first year, the proceeds generated by the equipment exactly equal AB's operating expenses. At the end of that year, the book value of the property is $9,000 ($10,000 less the $1,000 book depreciation deduction), and the adjusted tax basis is $3,600 ($4,000 less the $400 tax depreciation deduction). A's built-in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also, at the end of AB's first year, A has a $9,500 book capital account and a $4,000 tax basis in A's partnership interest. B has a $9,500 book capital account and a $9,600 adjusted tax basis in B's partnership interest.

(iii) *Sale of the property.* If AB sells the property at the beginning of AB's second year for $9,000, AB realizes tax gain of $5,400 ($9,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, the entire $5,400 gain must be allocated to A because the property A contributed has that much built-in gain remaining. If AB sells the property at the beginning of AB's second year for $10,000, AB realizes tax gain of $6,400 ($10,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, only $5,400 of gain must be allocated to A to account for A's built-in gain. The remaining $1,000 of gain is allocated equally between A and B in accordance with the partnership agreement. If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400, and the entire gain must be allocated to A.

(iv) *Termination and liquidation of partnership.* If AB sells the property at the beginning of AB's second year for $9,000, and AB engages in no other transactions that year, A will recognize a gain of $5,400, and B will recognize no income or loss. A's adjusted tax basis for A's interest in AB will then be $9,400 ($4,000, A's original tax basis, increased by the gain of $5,400). B's adjusted tax basis for B's interest in AB will be $9,600 ($10,000, B's original tax basis, less the $400 depreciation deduction in the first partnership year). If the partnership then terminates and distributes its assets ($19,000 in cash) to A and B in proportion to their capital account balances, A will recognize a capital gain of $100 ($9,500, the amount distributed to A, less $9,400, the adjusted tax basis of A's interest). B will recognize a capital loss of $100 (the excess of B's adjusted tax basis, $9,600, over the amount received, $9,500).

Example 2. Unreasonable use of the traditional method—(i) *Facts.* C and D form partnership CD and agree that each will be allocated a 50 percent share of all partnership items and that CD will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. C contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. At the time of contribution, C has a built-in gain of $9,000 and the equipment is section 704(c) property. D contributes $10,000 of cash, which CD uses to buy securities. D has substantial net operating loss carryforwards that D anticipates will otherwise expire unused. Under §1.704–1(b)(2)(iv)(*g*)(3), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. CD sells the equipment during the second year for $10,000 and recognizes a $10,000 gain ($10,000, the amount realized, less the adjusted tax basis of $0).

(ii) *Unreasonable use of method*—(A) At the beginning of the second year, both the book value and adjusted tax basis of the equipment are $0. Therefore, there is no remaining built-in gain. The $10,000 gain on the sale of the equipment in the second year is allocated $5,000 each to C and D. The interaction of the partnership's one-year write-off of the entire book value of the equipment and the use of the traditional method results in a shift of $4,000 of the precontribution gain in the equipment from C to D (D's $5,000 share of CD's $10,000 gain, less the $1,000 tax depreciation deduction previously allocated to D).

(B) The traditional method is not reasonable under paragraph (a)(10) of this section because the contribution of property is made, and the traditional method is used, with a view to shifting a significant amount of taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate.

(C) Under these facts, if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated first to C to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule of paragraph (a)(10) of this section. See paragraph (c)(3) of this section. Under other facts, (for example, if the partnership holds multiple section 704(c) properties and either uses multiple allocation methods or uses a single allocation method where one or more of the properties are subject to the ceiling rule) the allocation to C may not be reasonable.

(c) *Traditional method with curative allocations*—(1) *In general.* To correct distortions created by the ceiling rule, a partnership using the traditional method under paragraph (b) of this section may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is allocated to the contributing partner. A partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from a specific property or properties) even if the allocation of those available items does not offset fully the effect of the ceiling rule.

(2) *Consistency*. A partnership must be consistent in its application of curative allocations with respect to each item of section 704(c) property from year to year.

(3) *Reasonable curative allocations*—(i) *Amount.* A curative allocation is not reasonable to the extent it exceeds the amount necessary to offset the effect of the ceiling rule for the current taxable year or, in the case of a curative allocation upon disposition of the property, for prior taxable years.

(ii) *Timing.* The period of time over which the curative allocations are made is a factor in determining whether the allocations are reasonable. Notwithstanding paragraph (c)(3)(i) of this section, a partnership may make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution. See paragraph (c)(4) *Example 3* (ii)(C) of this section.

(iii) *Type*—(A) *In general.* To be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The expectation must exist at the time the section 704(c) property is obligated to be (or is) contributed to the partnership and the allocation with respect to that property becomes part of the partnership agreement. However, the expectation is tested at the time the allocation with respect to that property is actually made if the partnership agreement is not sufficiently specific as to the precise manner in which allocations are to be made with respect to that property. Under this paragraph (c), if the item limited by the ceiling rule is loss from the sale of property, a curative allocation of gain must be expected to have substantially the same effect as would an allocation to that partner of gain with respect to the sale of the property. If the item limited by the ceiling rule is depreciation or other cost recovery, a curative allocation of income to the contributing partner must be expected to have substantially the same effect as would an allocation to that partner of partnership income with respect to the contributed property. For example, if depreciation deductions with respect to leased equipment contributed by a tax-exempt partner are limited by the ceiling rule, a curative allocation of dividend or interest income to that partner generally is not reasonable, although a curative allocation of depreciation deductions from other leased equipment to the noncontributing partner is reasonable. Similarly, under this rule, if depreciation deductions apportioned to foreign source income in a particular statutory grouping under section 904(d) are limited by the ceiling rule, a curative allocation of income from another statutory grouping to the contributing partner generally is not reasonable, although a curative allocation of income from the same statutory grouping and of the same character is reasonable.

(B) *Exception for allocation from disposition of contributed property.* If cost recovery has been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule, but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation. For example, if allocations of depreciation deductions to a noncontributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property, if properly provided for in the partnership agreement, is reasonable for purposes of paragraph (c)(3)(iii)(A) of this section even if not of the same character.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Reasonable and unreasonable curative allocations—(i) *Facts.* E and F form partnership EF and agree that each will be allocated a 50 percent share of all partnership items and that EF will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. E contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The equipment has 10 years remaining on its cost recovery schedule and is depreciable using the straight-line method. At the time of contribution, E has a built-in gain of $6,000, and therefore, the equipment is section 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale. In EF's first year, the revenue generated by the equipment equals EF's operating expenses. The equipment generates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year EF sells all the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method of paragraph (b) of this section, E and F would each be allocated $350 of income from the sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would all be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	350	350	350	Sales income.
9,850	4,350	9,850	9,950	

(ii) *Reasonable curative allocation.* Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E under paragraph (c) of this section an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	450	350	250	Sales income.
9,850	4,450	9,850	9,850	

(iii) *Unreasonable curative allocation.* (A) The facts are the same as in paragraphs (i) and (ii) of this *Example 1,* except that E and F choose to allocate all the income from the sale of the inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	700	350	0	Sales income.
9,850	4,700	9,850	9,600	

(B) This curative allocation is not reasonable under paragraph (c)(3)(i) of this section because the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule.

Example 2. Curative allocations limited to depreciation—(i) *Facts.* G and H form partnership GH and agree that each will be allocated a 50 percent share of all partnership items and that GH will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section, but only to the extent that the partnership has sufficient tax depreciation deductions. G contributes property G1, with an adjusted tax basis of $3,000 and a fair market value of $10,000, and H contributes property H1, with an adjusted tax basis of $6,000 and a fair market value of $10,000. Both properties have 5 years remaining on their cost recovery schedules and are depreciable using the straight-line method. At the time of contribution, G1 has a built-in gain of $7,000 and H1 has a built-in gain of $4,000, and therefore, both properties are section 704(c) property. G1 generates $600 of tax depreciation and $2,000 of book depreciation for each of five years. H1 generates $1,200 of tax depreciation and $2,000 of book depreciation for each of 5 years. In addition, the properties each generate $500 of operating income annually. G and H are each allocated $1,000 of book depreciation for each property. Under the traditional method of paragraph (b) of this section, G would be allocated $0 of tax depreciation for G1 and $1,000 for H1, and H would be allocated $600 of tax depreciation for G1 and $200 for H1. Thus, at the end of the first year, G and H's book and tax capital accounts would be as follows:

G		H		
Book	Tax	Book	Tax	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<1,000>	<1,000>	<200>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,500	8,500	5,700	

(ii) *Curative allocations.* Under the traditional method, G is allocated more depreciation deductions than H, even though H contributed property with a smaller disparity reflected on GH's book and tax capital accounts. GH makes curative allocations to H of an additional $400 of tax depreciation each year, which reduces the disparities between G and H's book and tax capital accounts ratably each year. These allocations are reasonable provided the allocations meet the other requirements of this section. As a result of their agreement, at the end of the first year, G and H's capital accounts are as follows:

G		H		
Book	Tax	Book	Tax	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<600>	<1,000>	<600>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,900	8,500	5,300	

Example 3. Unreasonable use of curative allocations—(i) *Facts.* J and K form partnership JK and agree that each will receive a 50 percent share of all partnership items and that JK will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. J contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of

the fact that the equipment has only one year remaining on its cost recovery schedule although it has an estimated remaining economic life of 10 years. J has substantial net operating loss carryforwards that J anticipates will otherwise expire unused. At the time of contribution, J has a built-in gain of $9,000, and therefore, the equipment is section 704(c) property. K contributes $10,000 of cash, which JK uses to buy inventory for resale. In JK's first year, the revenues generated by the equipment exactly equal JK's operating expenses. Under §1.704–1(b)(2)(iv)(*g*)(*3*), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. In addition, at the end of the first year JK sells all of the inventory for $18,000, recognizing $8,000 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from J's contributed equipment. Under the traditional method of paragraph (b) of this section, J and K's book and tax capital accounts at the end of the first year would be as follows:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,000	4,000	4,000	Sales income.
9,000	5,000	9,000	13,000	

(ii) *Unreasonable use of method*. (A) The use of curative allocations under these facts to offset immediately the full effect of the ceiling rule would result in the following book and tax capital accounts at the end of JK's first year:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	8,000	4,000	0	Sales income.
9,000	9,000	9,000	9,000	

(B) This curative allocation is not reasonable under paragraph (a)(10) of this section because the contribution of property is made and the curative allocation method is used with a view to shifting a significant amount of partnership taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate, within a period of time significantly shorter than the economic life of the property.

(C) The property has only one year remaining on its cost recovery schedule even though its economic life is considerably longer. Under these facts, if the partnership agreement had provided for curative allocations over a reasonable period of time, such as over the property's economic life, rather than over its remaining cost recovery period, the allocations would have been reasonable. See paragraph (c)(3)(ii) of this section. Thus, in this example, JK would make a curative allocation of $400 of sales income to J in the partnership's first year (10 percent of $4,000). J and K's book and tax capital accounts at the end of the first year would be as follows:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,400	4,000	3,600	Sales income.
9,000	5,400	9,000	12,600	

(d) *Remedial allocation method*—(1) *In general*. A partnership may adopt the remedial allocation method described in this paragraph to eliminate distortions caused by the ceiling rule. A partnership adopting the remedial allocation method eliminates those distortions by creating remedial items and allocating those items to its partners. Under the remedial allocation method, the partnership first determines the amount of book items under paragraph (d)(2) of this section and the partners' distributive shares of these items under section 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method described in paragraph (b)(1) of this section. If the ceiling rule (as defined in paragraph (b)(1) of this section) causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

(2) *Determining the amount of book items.* Under the remedial allocation method, a partnership determines the amount of book items attributable to contributed property in the following manner rather than under the rules of § 1.704–1(b)(2)(iv)(*g*)(*3*). The portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered (generally, over the property's remaining recovery period under section 168(i)(7) or other applicable Internal Revenue Code section). The remainder of the partnership's book basis in the property (the amount by which book basis exceeds adjusted tax basis) is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution.

(3) *Type.* Remedial allocations of income, gain, loss, or deduction to the noncontributing partner have the same tax attributes as the tax item limited by the ceiling rule. The tax attributes of offsetting remedial allocations of income, gain, loss, or deduction to the contributing partner are determined by reference to the item limited by the ceiling rule. Thus, for example, if the ceiling rule limited item is loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be gain from the sale of that property. Conversely, if the ceiling rule limited item is gain from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be loss from the sale of that property. If the ceiling rule limited item is depreciation or other cost recovery from the contributed property, the offsetting remedial allocation to the contributing partner must be income of the type produced (directly or indirectly) by that property. Any partner level tax attributes are determined at the partner level. For example, if the ceiling rule limited item is depreciation from property used in a rental activity, the remedial allocation to the noncontributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies section 469 to the allocations as appropriate.

(4) *Effect of remedial items*—(i) *Effect on partnership.* Remedial items do not affect the partnership's computation of its taxable income under section 703 and do not affect the partnership's adjusted tax basis in partnership property.

(ii) *Effect on partners.* Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest.

(5) *Limitations on use of methods involving remedial allocations*—(i) *Limitation on taxpayers.* In the absence of published guidance, the remedial allocation method described in this paragraph (d) is the only reasonable section 704(c) method permitting the creation of notional tax items.

(ii) *Limitation on Internal Revenue Service.* In exercising its authority under paragraph (a)(10) of this section to make adjustments if a partnership's allocation method is not reasonable, the Internal Revenue Service will not require a partnership to use the remedial allocation method described in this paragraph (d) or any other method involving the creation of notional tax items.

(6) *Adjustments to application of method.* The Commissioner may, by published guidance, prescribe adjustments to the remedial allocation method under this paragraph (d) as necessary or appropriate. This guidance may, for example, prescribe adjustments to the remedial allocation method to prevent the duplication or omission of items of income or deduction or to reflect more clearly the partners' income or the income of a transferee of a partner.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Remedial allocation method—(i) *Facts.* On January 1, L and M form partnership LM and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under this paragraph (d) and that the straight-line method will be used to recover excess book basis. L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000, which the partnership uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year the partnership is formed.

(ii) *Years 1 through 4.* Under the remedial allocation method of this paragraph (d), LM has book depreciation for each of its first 4 years of $1,600 [$1,000 ($4,000 adjusted tax basis divided by the 4-year remaining recovery period) plus $600 ($6,000 excess of book value over tax basis, divided by the *new* 10-year recovery period)]. (For the purpose of simplifying the example, the partnership's book depreciation is determined without regard to any first-year depreciation conventions.) Under the partnership agreement, L and M are each allocated 50 percent ($800) of the book depreciation. M is allocated $800 of tax depreciation and L is allocated the remaining $200 of tax depreciation ($1,000–$800). See paragraph (d)(1) of this section. No remedial allocations are made because the ceiling rule does not result in a book allocation of depreciation to M different from the tax allocation. The allocations result in capital accounts at the end of LM's first 4 years as follows:

	L		M	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Depreciation	<3,200>	<800>	<3,200>	<3,200>
	$6,800	$3,200	$6,800	$6,800

(iii) *Subsequent years.* (A) For each of years 5 through 10, LM has $600 of book depreciation ($6,000 excess of initial book value over adjusted tax basis divided by the 10-year recovery period that commented in year 1), but no tax depreciation. Under the partnership agreement, the $600 of book depreciation is allocated equally to L and M. Because of the application of the ceiling rule in year 5, M would be allotted $300 of book depreciation, but no tax depreciation. Thus, at the end of LM's fifth year L's and M's book and tax capital accounts would be as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>	....	<300>	....
	$6,500	$3,200	$6,500	$6,800

(B) Because the ceiling rule would cause an annual disparity of $300 between M's allocations of book and tax depreciation, LM must make remedial allocations of $300 of tax depreciation deductions to M under the remedial allocation method for each of years 5 through 10. LM must also make an offsetting remedial allocation to L of $300 of taxable income, which must be of the same type as income produced by the property. At the end of year 5, LM's capital accounts are as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>	....	<300>	....
Remedial allocations	....	300	....	<300>
	$6,500	$3,500	$6,500	$6,500

(C) At the end of year 10, LM's capital accounts are as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 5	$6,500	$3,500	$6,500	$6,500
Depreciation	<1,500>	....	<1,500>	....
Remedial allocations	....	1,500	....	<1,500>
	$5,000	$5,000	$5,000	$5,000

Example 2. Remedial allocations on sale—(i) *Facts.* N and P form partnership NP and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that NP will make allocations under section 704(c) using the remedial allocation method under this paragraph (d). N contributes Blackacre (land) with an adjusted tax basis of $4,000 and a fair market value of $10,000. Because N has a built-in gain of $6,000, Blackacre is section 704(c) property. P contributes Whiteacre (land) with an adjusted tax basis and fair market value of $10,000. At the end of NP's first year, NP sells Blackacre to Q for $9,000 and recognizes a capital gain of $5,000 ($9,000 amount realized less $4,000 adjusted tax basis) and a book loss of $1,000 ($9,000 amount realized less $10,000 book basis). NP has no other items of income, gain, loss, or deduction. If the ceiling rule were applied, N would be allocated the entire $5,000 of tax gain and N and P would each be allocated $500 of book loss. Thus, at the end of NP's first year N's and P's book and tax capital accounts would be as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	....
	$9,500	$9,000	$9,500	$10,000

(ii) *Remedial allocation.* Because the ceiling rule would cause a disparity of $500 between P's allocation of book and tax loss, NP must make a remedial allocation of $500 of capital loss to P and an offsetting remedial allocation to N of an additional $500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	....
Remedial allocations	....	500	....	<500>
	$9,500	$9,500	$9,500	$9,500

Example 3. Remedial allocation where built-in gain property sold for book and tax loss—(i) *Facts.* The facts are the same as in Example 2, except that at the end of NP's first year, NP sells Blackacre to Q for $3,000 and recognizes a capital loss of $1,000 ($3,000 amount realized less $4,000 adjusted tax basis) and a book loss of $7,000 ($3,000 amount realized less $10,000 book basis). If the ceiling rule were applied, P would be allocated the entire $1,000 of tax loss and N and P would each be allocated $3,500 of book loss. Thus, at the end of NP's first year, N's and P's book and tax capital accounts would be as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
	$6,500	$4,000	$6,500	$9,000

(ii) *Remedial allocation.* Because the ceiling rule would cause a disparity of $2,500 between P's allocation of book and tax loss on the sale of Blackacre, NP must make a remedial allocation of $2,500 of capital loss to P and an offsetting remedial allocation to N of $2,500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution ..	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
Remedial Allocations	....	2,500	....	<2,500>

	N		P	
	Book	Tax	Book	Tax
	$6,500	$6,500	$6,500	$6,500

(e) *Exceptions and special rules*—(1) *Small disparities*—(i) *General rule.* If a partner contributes one or more items of property to a partnership within a single taxable year of the partnership, and the disparity between the book value of the property and the contributing partner's adjusted tax basis in the property is a small disparity, the partnership may—

(A) Use a reasonable section 704(c) method;

(B) Disregard the application of section 704(c) to the property; or

(C) Defer the application of section 704(c) to the property until the disposition of the property.

(ii) *Definition of small disparity.* A disparity between book value and adjusted tax basis is a small disparity if the book value of all properties contributed by one partner during the partnership taxable year does not differ from the adjusted tax basis by more than 15 percent of the adjusted tax basis, and the total gross disparity does not exceed $20,000.

(2) *Aggregation.* Each of the following types of property may be aggregated for purposes of making allocations under section 704(c) and this section if contributed by one partner during the partnership taxable year.

(i) *Depreciable property.* All property, other than real property, that is included in the same general asset account of the contributing partner and the partnership under section 168.

(ii) *Zero-basis property.* All property with a basis equal to zero, other than real property.

(iii) *Inventory.* For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section).

(3) *Special aggregation rule for securities partnerships*—(i) *General rule.* For purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of section 704(c). Notwithstanding paragraphs (a)(2) and (a)(6)(i) of this section, once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership. Paragraphs (e)(3)(iv) and (e)(3)(v) of this section describe approaches for aggregating reverse section 704(c) gains and losses that are generally reasonable. Other approaches may be reasonable in appropriate circumstances. See, however, paragraph (a)(10) of this section, which describes the circumstances under which section 704(c) methods, including the aggregate approaches described in this paragraph (e)(3), are not reasonable. A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.

(ii) *Qualified financial assets*—(A) *In general.* A qualified financial asset is any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in §1.1092(d)–1 (defining actively traded property for purposes of the straddle rules).

(B) *Management companies.* For a management company, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

(C) *Partnership interests.* An interest in a partnership is not a qualified financial asset for purposes of this paragraph (e)(3)(ii). However, for purposes of this paragraph (e)(3), a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets as follows:

(*1*) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and

(*2*) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

(iii) *Securities partnership*—(A) *In general.* A partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).

(B) *Definitions*—(*1*) *Management company.* A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

(*2*) *Investment partnership.* A partnership is an investment partnership if:

(*i*) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90 percent of the fair market value of the partnership's non-cash assets; and

(*ii*) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this paragraph (e)(3), to make revaluations at least annually.

(iv) *Partial netting approach.* This paragraph (e)(3)(iv) describes the partial netting approach of making reverse section 704(c) allocations. See Example 1 of paragraph (e)(3)(ix) of this section for an illustration of the partial netting approach. To use the partial netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the partial netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and

(C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

(v) *Full netting approach.* This paragraph (e)(3)(v) describes the full netting approach of making reverse section 704(c) allocations on an aggregate basis. See Example 2 of paragraph (e)(3)(ix) of this section for an illustration of the full netting approach. To use the full netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the full netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and

(C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

(vi) *Type of tax gain or loss.* The character and other tax attributes of gain or loss allocated to the partners under this paragraph (e)(3) must:

(A) Preserve the tax attributes of each item of gain or loss realized by the partnership;

(B) Be determined under an approach that is consistently applied; and

(C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

(vii) *Disqualified securities partnerships.* A securities partnership that adopts an aggregate approach under this paragraph (e)(3) and subsequently fails to qualify as a securities partnership must make reverse section 704(c) allocations on an asset-by-asset basis after the date of disqualification. The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse section 704(c) allocations on or after the date of disqualification.

(viii) *Transitional rule for qualified financial assets revalued after effective date.* A securities partnership revaluing its qualified financial assets pursuant to §1.704–1(b)(2)(iv)(*f*) on or after the effective date of this section may use any reasonable approach to coordinate with revaluations that occurred prior to the effective date of this section.

(ix) *Examples.* The following examples illustrate the principles of this paragraph (e)(3).

Example 1. Operation of the partial netting approach—(i) *Facts.* Two regulated investment companies, X and Y, each contribute $150,000 in cash to form PRS, a partnership that registers as a management company. The partnership agreement provides that book items will be allocated in accordance with the partners' relative book capital accounts, that book capital accounts will be adjusted to reflect daily revaluations of property pursuant to §1.704–1(b)(2)(iv)(*f*)(*5*)(*iii*), and that reverse section 704(c) allocations will be made using the partial netting approach described in paragraph (e)(3)(iv) of this section. X and Y each have an initial book capital account of $150,000. In addition, the partnership establishes for each of X and Y a revaluation account with a beginning balance of $0. On Day 1, PRS buys Stock 1, Stock 2, and Stock 3 for $100,000 each. On Day 2, Stock 1 increases in value from $100,000 to $102,000, Stock 2 increases in value from $100,000 to $105,000, and Stock 3 declines in value from $100,000 to $98,000. At the end of Day 2, Z, a regulated investment company, joins PRS by contributing $152,500 in cash for a one-third interest in the partnership [$152,500 divided by $300,000 (initial values of stock) +$5,000 (net gain at end of Day 2)+ $152,500]. PRS uses this cash to purchase Stock 4. PRS establishes a revaluation account for Z with a $0 beginning balance. As of the close of Day 3, Stock 1 increases in value from $102,000 to $105,000, and Stocks 2, 3, and 4 decrease in value from $105,000 to $102,000, from $98,000 to $96,000, and from $152,500 to $151,500, respectively. At the end of Day 3, PRS sells Stocks 2 and 3.

(ii) *Book allocations—Day 2.* At the end of Day 2, PRS revalues the partnership's qualified financial assets and increases X's and Y's book capital accounts by each partner's 50 percent share of the $5,000 ($2,000 + $5,000 − $2,000) net increase in the value of the partnership's assets during Day 2. PRS increases X's and Y's respective revaluation account balances by $2,500 each to reflect the amount by which each partner's book capital account increased on Day 2. Z's capital account is not affected because Z did not join PRS until the end of Day 2. At the beginning of Day 3, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	....
Day 2 Adjustment	2,000	5,000	(2,000)	....
Total	$102,000	$105,000	$98,000	$152,500

	X		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing Balance	$152,500	$150,000	$2,500

	Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing balance	$152,500	$150,000	$2,500

	Z		
	Book	Tax	Revaluation account
Opening Balance	....	....	....
Day 2 Adjustment	....	....	....
Closing Balance	$152,500	$152,500	$0

(iii) *Book and tax allocations—Day 3.* At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the $3,000 ($3,000—$3,000—$2,000—$1,000) net decrease in the value of the partnership's qualified financial assets. PRS also reduces each partner's revaluation account balance by $1,000. Accordingly, X's and Y's revaluation account balances are reduced to $1,500 each and Z's revaulation account balance is ($1,000). PRS then separately allocates the tax gain from the sale of Stock 2 and the tax loss from the sale of Stock 3. The $2,000 of tax gain recognized on the sale of Stock 2 ($102,000—$100,000) is allocated among the partners with positive revaluation account balances in accordance with the relative balances of those revaluation accounts. X's and Y's revaluation accounts have equal positive balances; thus, PRS allocates $1,000 of the gain from the sale of Stock 2 to X and $1,000 of that gain to Y. PRS allocates none of the gain from the sale to Z because Z's revaluation account balance is negative. The $4,000 of tax loss recognized from the sale of Stock 3 ($96,000—$100,000) is allocated first to the partners with negative revaluation account balances to the extent of those balances. Because Z is the only partner with a negative revaluation account balance, the tax loss is allocated first to Z to the extent of Z's ($1,000) balance. The remaining $3,000 of tax loss is allocated among the partners in accordance with their distributive shares of the loss. Accordingly, PRS allocates $1,000 of tax loss from the sale of Stock 3 to each of X and Y. PRS also allocates an additional $1,000 of the tax loss to Z, so that Z's total share of the tax loss from the sale of Stock 3 is $2,000. PRS then reduces each partner's revaluation account balance by the amount of any tax gain allocated to that partner and increases each partner's revaluation account balance by the amount of any tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	
Day 3 Adjustment	$3,000	(3,000)	(2,000)	(1,000)
Total	$105,000	$102,000	$96,000	$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$150,000	$1,500
Gain from Stock 2	0	$1,000	(1,000)
Loss from Stock 3	0	($1,000)	1,000
Closing Balance	$151,500	$150,000	$1,500

	Z		
	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Gain from Stock 2	0	0	0
Loss from Stock 3	0	(2,000)	2,000
Closing Balance	$151,500	$150,500	$1,000

Example 2. Operation of the full netting approach—(i) *Facts.* The facts are the same as in Example 1, except that the partnership agreement provides that PRS will make reverse section 704(c) allocations using the full netting approach described in paragraph (e)(3)(v) of this section.

(ii) *Book allocations—Days 2 and 3.* PRS allocates its book gains and losses in the manner described in paragraphs (ii) and (iii) of Example 1 (the partial netting approach). Thus, at the end of Day 2, PRS increases the book capital accounts of X and Y by $2,500 to reflect the appreciation in the parntership's assets from the close of Day 1 to the close of Day 2 and records that increase in the revaluation account created for each partner. At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the decline in value of the partnership's assets from Day 2 to Day 3 and reduces each partner's revaluation account by a corresponding amount.

(iii) *Tax allocations—Day 3.* After making the book adjustments described in the previous paragraph, PRS allocates its net tax gain (or net tax loss) from its sales of qualified financial assets during Day 3. To do so, PRS first determines its net tax gain (or net tax loss) recognized from its sales of qualified financial assets for the day. There is a $2,000 net tax loss ($2,000 gain from the sale of Stock 2 less $4,000 loss from the sale of Stock 3) on the sale of PRS's qualified financial assets. Because Z is the only partner with a negative revaluation account balance, the partnership's net tax loss is allocated first to Z to the extent of Z's ($1,000) revaluation account balance. The remaining net tax loss is allocated among the partners in accoradnce with their distributive shares of loss. Thus, PRS allocates $333.33 of the $2,000 net tax loss to each of X and Y. PRS also allocates an additional $333.33 of the net tax loss to Z, so that the total net tax loss allocation to Z is $1,333.33. PRS then increases each partner's revaluation account balance by the amount of net tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	....
Day 3 Adjustment	3,000	(3,000)	(2,000)	($1,000)
Total	$105,000	$102,000	$96,000	$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	$2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	(1,000)
Total	$151,500	$150,000	$1,500
Net Tax Loss-Stocks 2 & 3	0	(333)	333
Closing Balance	$151,500	$149,667	$1,833

	Z		
	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Net Tax Loss-Stocks 2 & 3	0	(1,333)	1,333
Closing Balance	$151,500	$151,167	$333

(4) *Aggregation as permitted by the Commissioner.* The Commissioner may, by published guidance or by letter ruling, permit:

(i) Aggregation of properties other than those described in paragraphs (e)(2) and (e)(3) of this section;

(ii) Partnerships and partners not described in paragraph (e)(3) of this section to aggregate gain and loss from qualified financial assets; and

(iii) Aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described in paragraph (e)(3) of this section.

(f) *Effective date.* With the exception of paragraph (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to §1.704–1(b)(2)(iv)*(f)* on or after December 21, 1993. Paragraph (a)(11) of this section applies to properties contributed by a partner to a partnership on or after August 20, 1997. However, partnerships may rely on paragraph (a)(11) of this section for properties contributed before August 20, 1997 and disposed of on or after August 20, 1997.

[T.D. 8500, 58 FR 67679, Dec. 22, 1993; 59 FR 4140, Jan. 28, 1994, as amended by T.D. 8585, 59 FR 66728, Dec. 28, 1994; 60 FR 11906, Mar. 3, 1995; T.D. 8717, 62 FR 25500, May 9, 1997; T.D. 8730, 62 FR 44215, Aug. 20, 1997]

§ 1.704–4 Distribution of contributed property.

(a) *Determination of gain and loss*—(1) *In general.* A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and §1.704–3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See §1.704–3(a)(3)(i) for a definition of section 704(c) property.

(2) *Transactions to which section 704(c)(1)(B) applies.* Section 704(c)(1)(B) and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731.

(3) *Fair market value of property.* The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct,