

§ 1.704-4

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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)
<b>Total .....</b>	<b>\$105,000</b>	<b>\$102,000</b>	<b>\$96,000</b>	<b>\$151,500</b>

	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)
<b>Total .....</b>	<b>\$151,500</b>	<b>\$150,000</b>	<b>\$1,500</b>
Net Tax Loss-Stocks 2 & 3 .....	0	(333)	333
<b>Closing Balance .....</b>	<b>\$151,500</b>	<b>\$149,667</b>	<b>\$1,833</b>

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

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.

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§ 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,

(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,

provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) *Determination of five-year period—*

(i) *General rule.* The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) does not begin a new five-year period for each partner with respect to the built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under § 1.708-1(b)(1)(iv). See § 1.704-3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property. This paragraph (a)(4)(ii) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a)(4)(ii) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a)(4)(ii) to the termination in a consistent manner.

(5) *Examples.* The following examples illustrate the rules of this paragraph (a). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example 1. Recognition of gain.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. Thus, there is a built-in gain of \$6,000 on Property A at the time of contribution. B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) and § 1.704-3 on the sale of Property A at the time of the dis-

tribution (\$10,000 fair market value less \$4,000 adjusted tax basis). As a result, A must recognize \$6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and § 1.704-3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

*Example 2. Effect of post-contribution depreciation deductions.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. Therefore, there is a built-in gain of \$10,000 on Property A. B and C each contribute \$30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in § 1.704-3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of \$3,000 per year (10 percent of the \$30,000 book basis), and each partner is allocated \$1,000 of book depreciation per year (one-third of the total annual book depreciation of \$3,000). The partnership has a tax depreciation deduction of \$2,000 per year (10 percent of the \$20,000 tax basis in Property A). This \$2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of the third year, the book value of Property A is \$21,000 (\$30,000 initial book value less \$9,000 aggregate book depreciation) and the adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is \$7,000 (\$21,000 book value less \$14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized \$7,000 of gain under section 704(c)(1)(A) and § 1.704-3(b). Therefore, A recognizes \$7,000 of gain on the distribution of Property A to B.

*Example 3. Effect of remedial method.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in § 1.704-3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased

to \$7,000, Property A1 is distributed to C in a current distribution. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the \$2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of \$7,000 less \$5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of \$3,000 (\$10,000 original book value less \$7,000 current fair market value of the property). Book loss in the amount of \$2,000 would have been allocated equally between B and C. Under the remedial method, \$2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, \$2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized \$4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 (\$2,000 of section 704(c) recognized gain plus \$2,000 remedial gain). Therefore, A recognizes \$4,000 of gain on the distribution of Property A1 to C under this section.

(b) *Character of gain or loss*—(1) *General rule.* Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) *Example.* The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example.* Character of gain. (i) On January 1, 1995, A and B form partnership AB. A contributes \$10,000 and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000, in exchange for a 25 percent interest in partnership capital and profits. B contributes \$60,000 cash for a 75 percent interest in partnership capital and profits.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. Property A is used in a trade or business of B.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) on a sale of Property A at the time of the distribution (the difference between the fair market value (\$10,000) and the adjusted tax basis (\$4,000) of

the property at that time). Because Property A is not a capital asset in the hands of Partner B and B holds more than 50 percent of partnership capital and profits, the character of the gain on a sale of Property A to B would have been ordinary income under section 707(b)(2). Therefore, the character of the gain to A on the distribution of Property A to B is ordinary income.

(c) *Exceptions*—(1) *Property contributed on or before October 3, 1989.* Section 704(c)(1)(B) and this section do not apply to property contributed to the partnership on or before October 3, 1989.

(2) *Certain liquidations.* Section 704(c)(1)(B) and this section do not apply to a distribution of an interest in section 704(c) property to a partner other than the contributing partner in a liquidation of the partnership if—

(i) The contributing partner receives an interest in the section 704(c) property contributed by that partner (and no other property); and

(ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 on a sale of the contributed property to an unrelated party immediately before the distribution.

(3) *Section 708(b)(1)(B) terminations.* Section 704(c)(1)(B) and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of section 704(c) property by the new partnership to a partner of the new partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the terminated partnership would have been subject to section 704(c)(1)(B). See also § 1.737-2(a) for a similar rule in the context of section 737. This paragraph (c)(3) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (c)(3) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (c)(3) to the termination in a consistent manner.

(4) *Complete transfer to another partnership.* Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See § 1.737-2(b) for a similar rule in the context of section 737.

(5) *Incorporation of a partnership.* Section 704(c)(1)(B) and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See § 1.737-2(c) for a similar rule in the context of section 737.

(6) *Undivided interests.* Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See § 1.737-2(d)(4) for the application of section 737 in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(7) *Example.* The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to

section 704(c)(1)(B), and all partners are unrelated.

*Example.* (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. Property B therefore has a built-in gain of \$10,000 at the time of contribution.

(ii) On December 31, 1998, the partnership liquidates when the fair market value of Property A has not changed, but the fair market value of Property B has increased to \$40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property B. This interest in Property B has a fair market value of \$10,000 to A, reflecting the fact that A was entitled to 50 percent of the \$20,000 post-contribution appreciation in Property B. The partnership distributes to B a 75 percent interest in Property B with a fair market value of \$30,000. B's basis in this portion of Property B is \$10,000 under section 732(b). As a result, B has a built-in gain of \$20,000 in this portion of Property B immediately after the distribution (\$30,000 fair market value less \$10,000 adjusted tax basis). This built-in gain is greater than the \$10,000 of built-in gain in Property B at the time of contribution to the partnership. B therefore does not recognize any gain on the distribution of a portion of Property B to A under this section.

(d) *Special rules—(1) Nonrecognition transactions.* Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the property received is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.737-2(d)(3) for a similar rule in the context of section 737.

(2) *Transfers of a partnership interest.* The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704-3(a)(7).

(3) *Distributions of like-kind property.* If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property

(within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the non-contributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See § 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

(4) *Example.* The following example illustrates the rules of this paragraph (d). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example.* Distribution of like-kind property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of \$8,000. The fair market value of Property X subsequently increases to \$10,000.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to

A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under § 1.707-3. A's basis in Property X is \$8,000 under section 732(a)(1). A therefore has \$2,000 of built-in gain in Property X (\$10,000 fair market value less \$8,000 adjusted tax basis).

(iii) A would generally recognize \$10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value (\$20,000) of the property and its adjusted tax basis (\$10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only \$8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) *Basis adjustments—(1) Contributing partner's basis in the partnership interest.*

The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property, other than like-kind property described in paragraph (d)(3) of this section (pertaining to the special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see § 1.737-3(a).

(2) *Partnership's basis in partnership property.* The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis

is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see § 1.737-3(b).

(3) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (e)(2) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See § 1.737-3(c)(4) for a similar rule in the context of section 737.

(4) *Example.* The following example illustrates the rules of this paragraph (e). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example.* Basis adjustment. On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. B and C each contribute \$20,000 cash.

(i) On December 31, 1998, Property A is distributed to B in a current distribution.

(iii) Under paragraph (a) of this section, A recognizes \$6,000 of gain on the distribution of Property A because that is the amount of gain that would have been allocated to A under section 704(c)(1)(A) and § 1.704-3 on a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A (\$10,000) less its adjusted tax basis at the time of distribution (\$4,000)). The adjusted tax basis of A's partnership interest is increased from \$14,000 to \$20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from \$4,000 to \$10,000 immediately prior to its distribution to B. B's adjusted tax basis in Property A is therefore \$10,000 under section 732(a)(1).

(f) *Anti-abuse rule—(1) In general.* The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See § 1.737-4 for an anti-abuse rule and examples in the context of section 737.

(2) *Examples.* The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example 1.* Distribution in substance made within five-year period; results inconsistent with the purpose of section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B and C each contribute \$10,000 cash.

(ii) On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, however, A would recognize \$9,000 of gain under section 704(c)(1)(B), the difference between the \$10,000 fair market value and the \$1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five years before December 31, 1998. On becoming aware of this

potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The actual distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 1* that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of \$9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

*Example 2. Suspension of five-year period in manner consistent with the purpose of section 704(c)(1)(B).* (i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair

market value of \$10,000 and an adjusted tax basis of \$1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes \$10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquiror of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for \$10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquiror of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of \$9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66730, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25500, May 9, 1997]