

interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example 1. The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of \$1,500 and has earned and retained an additional \$1,500. The total adjusted basis of partnership property is thus \$3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or \$1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example 2. Assume that partner A in example 1 of this paragraph sells his partnership interest to D for \$1,250 at a time when the partnership property with an adjusted basis of \$1,500 had appreciated in value to \$3,000, and when the partnership also had \$750 in cash. The total adjusted basis of all partnership property is \$2,250 and the value of such property is \$3,750. D's basis for his partnership interest is his cost, \$1,250. However, his one-third share of the adjusted basis of partnership property is only \$750. Therefore, for the purposes of the alternative rule, D has an adjustment of \$500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional \$1,500, its property will have an adjusted basis of \$3,750. D's adjusted basis for his interest under the alternative rule is \$1,750, determined by adding \$500, his basis adjustment to \$1,250 (his one-third share of the \$3,750 adjusted basis of partnership property). If the partnership distributes \$250 to each partner in a current distribution, D's adjusted basis for his interest will be \$1,500

(\$1,000, his one-third share of the remaining basis of partnership property, \$3,000, plus his basis adjustment of \$500).

Example 3. Assume that BCD partnership in example 2 of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash	\$3,000	\$3,000
Receivables	4,000	4,000
Depreciable property	5,000	5,000
Land held for investment	18,000	30,000
Total	30,000	42,000

Liabilities and capital	Per books
Liabilities	\$6,000
Capital accounts:	
B	4,500
C	4,500
D	15,000
Total	30,000

The \$15,000 representing the amount of D's capital account does not reflect the \$500 basis adjustment arising from D's purchase of his interest. See example 2 of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	\$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example 2	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule	17,500

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992; T.D. 8986, 67 FR 15114, Mar. 29, 2002; T.D. 9049, 68 FR 12816, Mar. 18, 2003]

§ 1.705-2 Basis adjustments coordinating sections 705 and 1032.

(a) *Purpose.* This section coordinates the application of sections 705 and 1032 and is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from

the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). However, in situations where a section 754 election was not in effect for the year in which a partner acquired its interest, the partner's inside basis and outside basis may not be equal. Similarly, in situations where a section 754 election was not in effect for the year in which a partnership distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted, the remaining partners' inside basis and outside basis may not be equal. In these situations, gain or loss allocated to the partner upon disposition of the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss) therefore generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allo-

cated to the corporate partner by the partnership.

(b) *Single partnership*—(1) *Required adjustments relating to acquisitions of partnership interest.* (i) This paragraph (b)(1) applies in situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the corporation acquired the interest, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(1) are illustrated by the following example:

Example. (i) A, B, and C form equal partnership PRS. Each partner contributes \$30,000 in exchange for its partnership interest. PRS has no liabilities. PRS purchases stock in corporation X for \$30,000, which appreciates in value to \$120,000. PRS also purchases inventory for \$60,000, which appreciates in value to \$150,000. A sells its interest in PRS to corporation X for \$90,000 in a year for which an election under section 754 is not in effect. PRS later sells the X stock for \$150,000. PRS realizes a gain of \$120,000 on the sale of the X stock. X's share of the gain is \$40,000. Under section 1032, X does not recognize its share of the gain.

(ii) Normally, X would be entitled to a \$40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the X stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which X acquired its interest in PRS, X would have been entitled to a basis adjustment under section 743(b) of \$60,000 (the excess of X's basis for the transferred partnership interest over X's share of the adjusted basis to PRS of PRS's property). See § 1.743-1(b). Under § 1.755-1(b), the basis adjustment under section 743(b) would have been allocated \$30,000 to the X stock (the amount of the gain that would have been allocated to X from the hypothetical sale of the stock), and \$30,000 to the inventory (the amount of the gain that

would have been allocated to X from the hypothetical sale of the inventory).

(iii) If a section 754 election had been in effect for the year in which X acquired its interest in PRS, the amount of gain that X would have recognized upon PRS's disposition of X stock (absent the application of section 1032) would be \$10,000 (X's share of PRS's gain from the stock sale, \$40,000, minus the amount of X's basis adjustment under section 743(b), \$30,000). See § 1.743-1(j). Accordingly, the increase in the basis of X's interest in PRS is \$10,000.

(2) *Required adjustments relating to distributions.* (i) This paragraph (b)(2) applies in situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the partnership made the distribution, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(2) are illustrated by the following example:

Example. (i) A, B, and corporation C form partnership PRS. A and B each contribute \$10,000 and C contributes \$20,000 in exchange for a partnership interest. PRS has no liabilities. PRS purchases stock in corporation C for \$10,000, which appreciates in value to \$70,000. PRS distributes \$25,000 to A in complete liquidation of A's interest in PRS in a year for which an election under section 754 is not in effect. PRS later sells the C stock for \$70,000. PRS realizes a gain of \$60,000 on the sale of the C stock. C's share of the gain is \$40,000. Under section 1032, C does not recognize its share of the gain.

(ii) Normally, C would be entitled to a \$40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the C stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which PRS made the distribution to A, PRS would

have been entitled to adjust the basis of partnership property under section 734(b)(1)(A) by \$15,000 (the amount of gain recognized by A with respect to the distribution to A under section 731(a)(1)). See § 1.734-1(b). Under § 1.755-1(c)(1)(ii), the basis adjustment under section 734(b) would have been allocated to the C stock, increasing its basis to \$25,000 (where there is a distribution resulting in an adjustment under section 734(b)(1)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property).

(iii) If a section 754 election had been in effect for the year in which PRS made the distribution to A, the amount of gain that PRS would have recognized upon PRS's disposition of C stock would be \$45,000 (\$70,000 minus \$25,000 basis in the C stock), and the amount of gain C would have recognized upon PRS's disposition of the C stock (absent the application of section 1032) would be \$30,000 (C's share of PRS's gain of \$45,000 from the stock sale). Accordingly, upon PRS's sale of the C stock, the increase in the basis of C's interest in PRS is \$30,000.

(c) *Tiered partnerships and other arrangements—(1) Required adjustments.* The purpose of these regulations as set forth in paragraph (a) of this section cannot be avoided through the use of tiered partnerships or other arrangements. For example, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section. Similarly, if a corporation owns an indirect interest in its own stock through a chain of two or more partnerships, and a partnership in the chain distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, then upon any subsequent sale or exchange of the stock, the bases of the interests in the partnerships included in the chain shall be adjusted in

a manner that is consistent with the purpose of this section.

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

Example 1. Acquisition of upper-tier partnership interest by corporation. (i) A, B, and C form a partnership (UTP), with each partner contributing \$25,000. UTP and D form a partnership (LTP). UTP contributes \$75,000 in exchange for its interest in LTP, and D contributes \$25,000 in exchange for D's interest in LTP. Neither UTP nor LTP has any liabilities. LTP purchases stock in corporation E for \$100,000, which appreciates in value to \$1,000,000. C sells its interest in UTP to corporation E for \$250,000 in a year for which an election under section 754 is not in effect for UTP or LTP. LTP later sells the E stock for \$2,000,000. LTP realizes a \$1,900,000 gain on the sale of the E stock. UTP's share of the gain is \$1,425,000, and E's share of the gain is \$475,000. Under section 1032, E does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the E stock (including E's share) were to increase the basis of UTP's interest in LTP, UTP's basis in such interest would be \$1,500,000 (\$75,000 + \$1,425,000). The fair market value of UTP's interest in LTP is \$1,500,000. Because UTP did not have a section 754 election in effect for the taxable year in which E acquired its interest in UTP, UTP's basis in the LTP interest does not reflect the purchase price paid by E for its interest. Increasing the basis of UTP's interest in LTP by the full amount of the gain that would be recognized (in the absence of section 1032) on the sale of the E stock preserves the conformity between UTP's inside basis and outside basis with respect to LTP (i.e., UTP's share of LTP's cash is equal to \$1,500,000, and UTP's basis in the LTP interest is \$1,500,000) and appropriately would cause UTP to recognize no gain or loss on the sale of UTP's interest in LTP immediately after the sale of the E stock. Accordingly, increasing the basis of UTP's interest in LTP by the entire amount of gain allocated to UTP (including E's share) from LTP's sale of the E stock is consistent with the purpose of this section. The \$1,425,000 of gain allocated by LTP to UTP will increase the adjusted basis of UTP's interest in LTP under section 705(a)(1). The basis of UTP's interest in LTP immediately after the sale of the E stock is \$1,500,000.

(iii) With respect to the basis of E's interest in UTP, if E's share of the gain allocated to UTP and then to E were to increase the basis of E's interest in UTP, E's basis in such interest would be \$725,000 (\$250,000 + \$475,000) and the fair market value of such interest would be \$500,000, so that E would recognize

a loss of \$225,000 if E sold its interest in UTP immediately after LTP's disposition of the E stock. It would be inappropriate for E to recognize a taxable loss of \$225,000 upon a disposition of its interest in UTP because E would not incur an economic loss in the transaction, and E did not recognize a taxable gain upon LTP's disposition of the E stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing E's basis in its UTP interest by the entire amount of gain allocated to E from the sale of the E stock is not consistent with the purpose of this section. (Conversely, because A and B were allocated taxable gain on the disposition of the E stock, it would be appropriate to increase A's and B's bases in their respective interests in UTP by the full amount of the gain allocated to them.)

(iv) The appropriate basis adjustment for E's interest in UTP upon the disposition of the E stock by LTP can be determined as the amount of gain that E would have recognized (in the absence of section 1032) upon the sale by LTP of the E stock if both UTP and LTP had made section 754 elections for the taxable year in which E acquired the interest in UTP. If section 754 elections had been in effect for UTP and LTP for the year in which E acquired E's interest in UTP, the following would occur. E would be entitled to a \$225,000 positive basis adjustment under section 743(b) with respect to the property of UTP. The entire basis adjustment would be allocated to UTP's only asset, its interest in LTP. In addition, the sale of C's interest in UTP would be treated as a deemed sale of E's share of UTP's interest in LTP for purposes of sections 754 and 743. The deemed selling price of E's share of UTP's interest in LTP would be \$250,000 (E's share of UTP's adjusted basis in LTP, \$25,000, plus E's basis adjustment under section 743(b) with respect to the assets of UTP, \$225,000). The deemed sale of E's share of UTP's interest in LTP would trigger a basis adjustment under section 743(b) of \$225,000 with respect to the assets of LTP (the excess of E's share of UTP's adjusted basis in LTP, including E's basis adjustment (\$225,000), \$250,000, over E's share of the adjusted basis of LTP's property, \$25,000). This \$225,000 adjustment by LTP would be allocated to LTP's only asset, the E stock, and would be segregated and allocated solely to E. The amount of LTP's gain from the sale of the E stock (before considering section 743(b)) would be \$1,900,000. E's share of this gain, \$475,000, would be offset in part by the \$225,000 basis adjustment under section 743(b), so that E would recognize gain equal to \$250,000 in the absence of section 1032.

(v) If the basis of E's interest in UTP were increased by \$250,000, the total basis of E's interest would equal \$500,000. This would conform to E's share of UTP's basis in the LTP interest ($\$1,500,000 \times 1/3 = \$500,000$) as well

as E's indirect share of the cash held by LTP ($(1/3 \times 3/4) \times \$2,000,000 = \$500,000$). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by E on a subsequent disposition of E's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the \$475,000 gain allocated to E, only \$250,000 will apply to increase the adjusted basis of E in UTP under section 705(a)(1). E's adjusted basis in its UTP interest following the sale of the E stock is \$500,000.

Example 2. Acquisition of lower-tier partnership interest by upper-tier partnership. (i) A, corporation B, and C form an equal partnership (LTP), with each partner contributing \$100,000. D, E, and F also form an equal partnership (LTP), with each partner contributing \$30,000. LTP purchases stock in corporation B for \$90,000, which appreciates in value to \$900,000. LTP has no liabilities. UTP purchases D's interest in LTP for \$300,000. LTP does not have an election under section 754 in effect for the taxable year of UTP's purchase. LTP later sells the B stock for \$900,000. UTP's share of the gain is \$270,000, and B's share of that gain is \$90,000. Under section 1032, B does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the B stock (including B's share) were to increase the basis of UTP's interest in LTP, UTP's basis in the LTP interest would be \$570,000 ($\$300,000 + \$270,000$), and the fair market value of such interest would be \$300,000, so that B would be allocated a loss of \$90,000 ($(\$570,000 - \$300,000) \times 1/3$) if UTP sold its interest in LTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of UTP's interest in LTP. B would not incur an economic loss in the transaction, and B was not allocated a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of UTP's interest in LTP. Accordingly, increasing UTP's basis in its LTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because E and F were allocated taxable gain on the disposition of the B stock, it would be appropriate to increase E's and F's bases in their respective interests in LTP by the full amount of such gain.)

(iii) The appropriate basis adjustment for UTP's interest in LTP upon the disposition of the B stock by LTP can be determined as the amount of gain that UTP would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that subsequently is allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which

UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a \$90,000 positive basis adjustment under section 743(b), allocable to B, in the property of LTP. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be \$810,000. UTP's share of this gain, \$270,000, would be offset, in part, by the basis adjustment under section 743(b), so that UTP would recognize gain equal to \$180,000.

(iv) If the basis of UTP's interest in LTP were increased by \$180,000, the total basis of UTP's partnership interest would equal \$480,000. This would conform to the sum of UTP's share of the cash held by LTP ($(1/3 \times \$900,000 = \$300,000)$) and the taxable gain recognized by A and C on the disposition of the B stock that appropriately may be offset on the disposition of their interests in UTP ($\$90,000 + \$90,000 = \$180,000$). Such a basis adjustment does not inappropriately create the opportunity for the allocation of a loss to B on a subsequent disposition of UTP's interest in LTP and is consistent with the purpose of this section. Accordingly, of the \$270,000 gain allocated to UTP, only \$180,000 will apply to increase the adjusted basis of UTP in LTP under section 705(a)(1). Such \$180,000 basis increase must be segregated and allocated \$90,000 each to solely A and C. UTP's adjusted basis in its LTP interest following the sale of the B stock is \$480,000.

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of \$190,000 ($\$100,000 + \$90,000$) and a value of \$100,000, so that B would recognize a loss of \$90,000 if B sold its interest in UTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective

interests in UTP by the amount of gain recognized by A and C.)

(vi) The appropriate basis adjustment for B's interest in UTP upon the disposition of the B stock by LTP can be determined as the amount of gain that B would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that is subsequently allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a basis adjustment under section 743(b) in the property of LTP of \$90,000 with respect to B. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be \$810,000. UTP's share of this gain, \$270,000, would be offset, in part, by the \$90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to \$180,000. The \$90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal \$100,000. This would conform to B's share of UTP's basis in the LTP interest $((\$480,000 - \$180,000) \times 1/3 = \$100,000)$ as well as B's indirect share of the cash held by LTP $((1/3 \times 1/3) \times \$900,000 = \$100,000)$. Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the \$90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is \$100,000.

(viii) Immediately after LTP's disposition of the B stock, UTP sells its interest in LTP for \$300,000. UTP's adjusted basis in its LTP interest is \$480,000, \$180,000 of which must be allocated \$90,000 each to A and C. Accordingly, upon UTP's sale of its interest in LTP, UTP realizes \$180,000 of loss, and A and C in turn each realize \$90,000 of loss.

(d) *Positions in Stock.* For purposes of this section, stock includes any position in stock to which section 1032 applies.

(e) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occur-

ring after December 6, 1999, except that paragraph (d) of this section is applicable with respect to sales or exchanges of stock occurring on or after March 29, 2002, and the fourth sentence of paragraph (a), paragraph (b)(2), and the third sentence of paragraph (c)(1) of this section are applicable with respect to sales or exchanges of stock occurring on or after March 18, 2003.

[T.D. 8986, 67 FR 15114, Mar. 29, 2002, as amended by T.D. 9049, 68 FR 12816, Mar. 18, 2003]

§ 1.706-1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible.* (1) In computing taxable income for a taxable year, a partner is required to include the partner's distributive share of partnership items set forth in section 702 and the regulations thereunder for any partnership taxable year ending within or with the partner's taxable year. A partner must also include in taxable income for a taxable year guaranteed payments under section 707(c) that are deductible by the partnership under its method of accounting in the partnership taxable year ending within or with the partner's taxable year.

(2) The rules of this paragraph (a)(1) may be illustrated by the following example:

Example. Partner A reports income using a calendar year, while the partnership of which A is a member reports its income using a fiscal year ending May 31. The partnership reports its income and deductions under the cash method of accounting. During the partnership taxable year ending May 31, 2002, the partnership makes guaranteed payments of \$120,000 to A for services and for the use of capital. Of this amount, \$70,000 was paid to A between June 1 and December 31, 2001, and the remaining \$50,000 was paid to A between January 1 and May 31, 2002. The entire \$120,000 paid to A is includible in A's taxable income for the calendar year 2002 (together with A's distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 2002).

(3) If a partner receives distributions under section 731 or sells or exchanges all or part of a partnership interest, any gain or loss arising therefrom does not constitute partnership income.