

step-up in basis in the distributed marketable securities in the hands of *A* by reason of section 731(c).

*Example 7. Coordination with section 737.* (i) *A* and *B* form partnership *AB*. *A* contributes Property *A*, nondepreciable real property with a fair market value of \$200 and an adjusted basis of \$100 in exchange for a 25 percent interest in partnership capital and profits. *AB* owns marketable Security *X*.

(ii) Within five years of the contribution of Property *A*, *AB* subsequently distributes Security *X*, with a fair market value of \$120 and an adjusted tax basis of \$100, to *A* in a current distribution that is subject to section 737. As part of the same distribution, *AB* distributes Property *Y* to *A* with a fair market value of \$20 and an adjusted tax basis of \$0. At the time of distribution, there has been no change in the fair market value of Property *A* or the adjusted tax basis in *A*'s interest in the partnership.

(iii) If *AB* had sold Security *X* for fair market value immediately before the distribution to *A*, the partnership would have recognized \$20 of gain. *A*'s distributive share of this gain would have been \$5 (25 percent of \$20 gain). Because *AB* has no other marketable securities, *A*'s distributive share of gain in partnership securities after the distribution would have been \$0. As a result, the distribution resulted in a decrease of \$5 in *A*'s share of the net gain in *AB*'s securities (\$5 net gain before distribution minus \$0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by \$5. The distribution of Security *X* is therefore treated as a distribution of \$115 of money to *A* (\$120 fair market value of Security *X* minus \$5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money (\$5) is treated as other property for purposes of section 737.

(iv) *A* recognizes total gain of \$40 on the distribution. *A* recognizes \$15 of gain under section 731(a)(1) on the distribution of the portion of Security *X* treated as money (\$115 distribution of money less \$100 adjusted tax basis in *A*'s partnership interest). *A* recognizes \$25 of gain under section 737 on the distribution of Property *Y* and the portion of Security *X* that is not treated as money. *A*'s section 737 gain is equal to the lesser of (i) *A*'s precontribution gain (\$100) or (ii) the excess of the fair market value of property received (\$20 fair market value of Property *Y* plus \$5 portion of Security *X* not treated as money) over the adjusted basis in *A*'s interest in the partnership immediately before the distribution (\$100) reduced (but not below zero) by the amount of money received in the distribution (\$115).

(v) *A*'s adjusted tax basis in Security *X* is \$115 (\$100 basis of Security *X* determined under section 732(a) plus \$15 of gain recog-

nized by reason of section 731(c)). *A*'s adjusted tax basis in Property *Y* is \$0 under section 732(a). The basis in *A*'s interest in the partnership is \$25 (\$100 basis before distribution minus \$100 basis allocated to Security *X* under section 732(a) plus \$25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

[T.D. 8707, 61 FR 67938, Dec. 26, 1996; 62 FR 8086, Feb. 21, 1997]

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

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* Partner *A*, with an adjusted basis of \$15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of \$10,000 to the partnership immediately before distribution, and \$2,000 cash. The basis of the property in *A*'s hands will be \$10,000. Under sections 733 and 705, the basis of *A*'s partnership interest will be reduced by the distribution to \$3,000 (\$15,000 less \$2,000 cash, less \$10,000, the basis of the distributed property to *A*).

*Example 2.* Partner *R* has an adjusted basis of \$10,000 for his partnership interest. He receives a current distribution of \$4,000 cash and property with an adjusted basis to the partnership of \$8,000. The basis of the distributed property to partner *R* is limited to \$6,000 (\$10,000, the adjusted basis of his interest, reduced by \$4,000, the cash distributed).

(b) *Distribution in liquidation.* Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership,

the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

*Example.* Partner B, with a partnership interest having an adjusted basis to him of \$12,000, retires from the partnership and receives cash of \$2,000, and real property with an adjusted basis to the partnership of \$6,000 and a fair market value of \$14,000. The basis of the real property to B is \$10,000 (B's basis for his partnership interest, \$12,000, reduced by \$2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner—(1) General rule—(i) Unrealized receivables and inventory items.* The basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in paragraph (c)(2)(i) of this section.

(ii) *Other distributed property.* Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in paragraph (c)(2) of this section.

(2) *Adjustment to basis allocation—(i) Decrease in basis.* Any decrease to the basis of distributed property required

under paragraph (c)(1) of this section is allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation before any decrease (but only to the extent of each property's unrealized depreciation). If the required decrease exceeds the amount of unrealized depreciation in the distributed property, the excess is allocated to the distributed property in proportion to the adjusted bases of the distributed property, as adjusted pursuant to the immediately preceding sentence.

(ii) *Increase in basis.* Any increase to the basis of distributed property required under paragraph (c)(1)(ii) of this section is allocated first to distributed property (other than unrealized receivables and inventory items) with unrealized appreciation in proportion to each property's respective amount of unrealized appreciation before any increase (but only to the extent of each property's unrealized appreciation). If the required increase exceeds the amount of unrealized appreciation in the distributed property, the excess is allocated to the distributed property (other than unrealized receivables or inventory items) in proportion to the fair market value of the distributed property.

(3) *Unrealized receivables and inventory items.* If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of the partnership interest.

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

*Example 1.* A is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of \$650. PRS distributes inventory items and Assets X and Y to A in liquidation of A's entire partnership interest. The distributed inventory items have a basis to the partnership of \$100 and a fair market value of \$200. Asset X has an adjusted basis to the partnership of \$50 and a fair

market value of \$400. Asset Y has an adjusted basis to the partnership and a fair market value of \$100. Neither Asset X nor Asset Y consists of inventory items or unrealized receivables. Under this paragraph (c), A's basis in its partnership interest is allocated first to the inventory items in an amount equal to their adjusted basis to the partnership. A, therefore, has an adjusted basis in the inventory items of \$100. The remaining basis, \$550, is allocated to the distributed property first in an amount equal to the property's adjusted basis to the partnership. Thus, Asset X is allocated \$50 and Asset Y is allocated \$100. Asset X is then allocated \$350, the amount of unrealized appreciation in Asset X. Finally, the remaining basis, \$50, is allocated to Assets X and Y in proportion to their fair market values: \$40 to Asset X ( $400/500 \times \$50$ ), and \$10 to Asset Y ( $100/500 \times \$50$ ). Therefore, after the distribution, A has an adjusted basis of \$440 in Asset X and \$110 in Asset Y.

*Example 2.* B is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of \$200. PRS distributes Asset X and Asset Y to B in liquidation of its entire partnership interest. Asset X has an adjusted basis to the partnership and fair market value of \$150. Asset Y has an adjusted basis to the partnership of \$150 and a fair market value of \$50. Neither of the assets consists of inventory items or unrealized receivables. Under this paragraph (c), B's basis is first assigned to the distributed property to the extent of the partnership's basis in each distributed property. Thus, Asset X and Asset Y are each assigned \$150. Because the aggregate adjusted basis of the distributed property, \$300, exceeds the basis to be allocated, \$200, a decrease of \$100 in the basis of the distributed property is required. Assets X and Y have unrealized depreciation of zero and \$100, respectively. Thus, the entire decrease is allocated to Asset Y. After the distribution, B has an adjusted basis of \$150 in Asset X and \$50 in Asset Y.

*Example 3.* C, a partner in partnership PRS, receives a distribution in liquidation of its entire partnership interest of \$6,000 cash, inventory items having an adjusted basis to the partnership of \$6,000, and real property having an adjusted basis to the partnership of \$4,000. C's basis in its partnership interest is \$9,000. The cash distribution reduces C's basis to \$3,000, which is allocated entirely to the inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

*Example 4.* Assume the same facts as in *Example 3* of this paragraph except C receives a distribution in liquidation of its entire partnership interest of \$1,000 cash and inventory

items having a basis to the partnership of \$6,000. The cash distribution reduces C's basis to \$8,000, which can be allocated only to the extent of \$6,000 to the inventory items. The remaining \$2,000 basis, not allocable to the distributed property, constitutes a capital loss to partner C under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(5) *Effective date.* This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(d) *Special partnership basis to transferee under section 732(d).* (1)(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and §§ 1.743-1 and 1.732-2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under

section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed or by the partnership. (For a shift of transferee's basis adjustment under section 743(b) to like property, see § 1.743-1(g).)

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

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

	Assets	
	Adjusted basis to PRS	Fair market value
Cash .....	\$1,500	\$1,500
Inventory .....	3,500	4,000
Asset X .....	2,000	4,000
Asset Y .....	4,000	5,000

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

the partnership, plus \$2,000, the amount of unrealized appreciation in Asset X, plus \$1,111 (\$4,000/\$9,000 multiplied by \$2,500)). Similarly, the adjusted basis of Asset Y to T is \$6,389 (\$4,000, the adjusted basis of Asset Y to the partnership, plus \$1,000, the amount of unrealized appreciation in Asset Y, plus, \$1,389 (\$5,000/\$9,000 multiplied by \$2,500)).

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return:

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest:

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

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

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

(5) *Required statements.* If a transferee partner notifies a partnership that it plans to make the election under section 732(d) under paragraph (d)(3) of this section, or if a partnership makes a distribution to which paragraph (d)(4) of this section applies, the partnership must provide the transferee with such information as is necessary for the transferee properly to compute the transferee's basis adjustments under section 732(d).

(e) *Exception.* When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or ex-

change of property under the provisions of section 751(b). In such case, section 732 (including subsection(d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of §1.751-1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69907, Dec. 15, 1999]

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

(a) *Adjustments under section 734(b).* In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section 743(b).* In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

*Example.* Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of