

in the partnership to D on January 1, 1971. The partnership may elect under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b). Unless an extension of time to make the election is obtained under the provisions of § 1.9100-1, the election must be made in a written statement filed with the partnership return for 1971 and must contain the information specified in subparagraph (1) of this paragraph. Such return must be filed by April 17, 1972 (unless an extension of time for filing the return is obtained). The election will apply to all distributions of property to a partner and transfers of an interest in the partnership occurring in 1971 and subsequent years, unless revoked pursuant to paragraph (c) of this section.

(c) *Revocation of election.* (1) *In general.* A partnership having an election in effect under this section may revoke such election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the internal revenue district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

(2) *Revocations effective on December 15, 1999.* Notwithstanding paragraph (c)(1) of this section, any partnership having an election in effect under this section for its taxable year that includes December 15, 1999, may revoke

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

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

#### § 1.755-1 Rules for allocation of basis.

(a) *In general—(1) Scope.* This section provides rules for allocating basis adjustments under sections 743(b) and 734(b) among partnership property. If there is a basis adjustment to which this section applies, the basis adjustment is allocated among the partnership's assets as follows. First, the partnership must determine the value of each of its assets under paragraphs (a)(2) through (5) of this section. Second, the basis adjustment is allocated between the two classes of property described in section 755(b). These classes of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class. Basis adjustments under section 743(b) are allocated among partnership assets

under paragraph (b) of this section. Basis adjustments under section 734(b) are allocated among partnership assets under paragraph (c) of this section.

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

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

(4) *Partnership gross value—(i) Basis adjustments under section 743(b)—(A) In general.* Except as provided in paragraph (a)(4)(ii) of this section, in the case of a basis adjustment under section 743(b), partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).

(B) *Special situations.* In certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles

held by the partnership. In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

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

(ii) *Basis adjustments under section 743(b) resulting from substituted basis transactions.* This paragraph (a)(4)(ii) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

(iii) *Basis adjustments under section 734(b).* In the case of a basis adjustment under section 734(b), partnership gross value equals the value of the entire

partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution.

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

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

(B) To goodwill and going concern value.

(ii) *Values assigned to section 197 intangibles other than goodwill and going concern value*. The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the ex-

tent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

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

(6) *Examples*. The provisions of paragraphs (a)(2) through (5) are illustrated by the following examples, which assume that the partnerships have an election in effect under section 754 at the time of the transfer and that the assets of each partnership constitute a trade or business (as described in § 1.1060-1(b)(2)). Except as provided, no partnership asset (other than inventory) is property described in section 751(a), and partnership liabilities are secured by all partnership assets. The examples are as follows:

*Example 1.* (i) A is the sole general partner in PRS, a limited partnership having three equal partners. PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two other assets with fair market values (determined using all the facts and circumstances) as follows: inventory worth \$1,000,000 and a building (a capital asset) worth \$2,000,000. The fair

market value of each of Intangible 1 and Intangible 2 is \$50,000. PRS has one liability of \$1,000,000, for which A bears the entire risk of loss under section 752 and the regulations thereunder. D purchases A's partnership interest for \$650,000, resulting in a basis adjustment under section 743(b). After the purchase, D bears the entire risk of loss for PRS's liability under section 752 and the regulations thereunder. Therefore, D's basis in its interest in PRS is \$1,650,000.

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

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

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

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

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is \$1,000,000 (the excess of partnership gross value, \$4,000,000, over the aggregate value of assets other than section 197 intangibles, \$3,000,000 (the sum of the value of the inventory, \$1,000,000, and the value of the building, \$2,000,000)). The partnership must determine the values of section 197 assets by allocating the residual section 197 intangibles value among the partnership's assets. The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, \$300,000 is assigned to each of Intangible 1

and Intangible 2, and \$400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, \$1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, \$600,000). D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

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

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

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

*Example 4.* Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each \$300,000, and that A does not sell its interest in PRS. Instead, A contributes its interest in PRS to E, a newly formed corporation wholly-owned by A, in a transaction described in section 351. Assume that the contribution results in a basis adjustment under section 743(b) (other than zero). PRS determines that its value as a going concern immediately following the contribution is \$3,000,000. Under

paragraph (a)(4)(ii) of this section, partnership gross value is \$4,000,000 (the value of PRS as a going concern, \$3,000,000, increased by the partnership's liability, \$1,000,000, immediately after the contribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value is \$1,000,000 (the amount by which partnership gross value, \$4,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, \$3,000,000). Of the residual section 197 intangibles value, \$300,000 is assigned to each of Intangible 1 and Intangible 2, and \$400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, \$1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, \$600,000). E's section 743(b) adjustment must be allocated under paragraph (b)(5) of this section using these assigned fair market values.

*Example 5.* G is the sole general partner in PRS, a limited partnership having three equal partners (G, H, and I). PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two capital assets with fair market values (determined using all the facts and circumstances) as follows: Vacant land worth \$1,000,000, and a building worth \$2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is \$300,000. PRS has one liability of \$1,000,000, for which G bears the entire risk of loss under section 752 and the regulations thereunder. PRS distributes the land to H in liquidation of H's interest in PRS. Immediately prior to the distribution, PRS's basis in the land is \$800,000, and H's basis in its interest in PRS is \$750,000. The distribution causes the partnership to increase the basis of its remaining property by \$50,000 under section 734(b)(1)(B). PRS determines that its value as a going concern immediately following the distribution is \$2,000,000. Under paragraph (a)(4)(iii) of this section, partnership gross value is \$3,000,000 (the value of PRS as a going concern, \$2,000,000, increased by the partnership's liability, \$1,000,000, immediately after the distribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value of PRS's section 197 intangibles is \$1,000,000 (the amount by which partnership gross value, \$3,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, \$2,000,000). Of the residual section 197 intangibles value, \$300,000 is assigned to each of Intangible 1 and Intangible 2, and \$400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, \$1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, \$600,000). PRS's section 734(b) adjustment must be allocated under paragraph (c) of this

section using these assigned fair market values.

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

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

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

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the basis adjustment to capital gain property is equal to—

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

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

be applied to reduce the basis of ordinary income property.

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

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

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

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

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

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

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

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

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

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

(iii) If, immediately after the transfer of the partnership interest to T, PRS sold all of its assets in a fully taxable transaction at fair market value, T would be allocated a loss of \$125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is (\$125). The amount of the basis adjustment to capital gain property is \$125 (zero, the amount of the basis adjustment under section 743(b), less (\$125), the amount of the basis adjustment allocated to ordinary income property).

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

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

(B) The product of—

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

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

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

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

(B) The product of—

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

the negative basis adjustment to capital gain property; multiplied by

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

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

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

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

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

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

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

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

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

*Example 2.* (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section, except that A sold its interest in PRS to T for \$110,000 rather than \$120,000. T, therefore, receives a basis adjustment under section 743(b) of \$35,000. Of the \$35,000 basis adjustment, (\$1,250) is allocated to ordinary income property, and \$36,250 is allocated to capital gain property.

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

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

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

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

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

*Example.* (i) A and B are equal partners in personal service partnership PRS. In 2004, as a result of B's death, B's partnership interest

is transferred to T when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows (based on all the facts and circumstances):

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

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

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

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

(v) At the time of the transfer, B's share of the partnership's basis in partnership assets



is \$1,000. Accordingly, T receives a \$1,500 basis adjustment under section 743(b). Under this paragraph (b)(4), the entire basis adjustment is allocated to the partnership's section 197 intangible.

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

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

be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Where, under the preceding sentence, a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss which would be allocated to the transferee from the sale of all assets in each class.

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

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

(C) *Limitation in decrease of basis.* Where, as the result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's

share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.

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

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

*Example 1.* A is a member of partnership LTP, which has made an election under section 754. The three partners in LTP have equal interests in capital and profits. Solely in exchange for a partnership interest in UTP, A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its partnership interest (\$5,000) equals its share of inside basis (also \$5,000). Under section 723, UTP's basis in its interest in LTP is

\$5,000. LTP's only two assets on the date of contribution are inventory with a basis of \$5,000 and a fair market value of \$7,500, and a nondepreciable capital asset with a basis of \$10,000 and a fair market value of \$7,500. The amount of the basis adjustment under section 743(b) to partnership property is \$0 (\$5,000, UTP's basis in its interest in LTP, minus \$5,000, UTP's share of LTP's basis in partnership assets). Because UTP acquired its interest in LTP in a substituted basis transaction, and the total amount of the basis adjustment under section 743(b) is zero, UTP receives no special basis adjustments under section 743(b) with respect to the partnership property of LTP.

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

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

  

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

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of UTP's interest in LTP and UTP's share of the adjusted basis to LTP of partnership property. UTP's interest in the previously taxed capital of LTP is \$15,000 (\$22,000, the amount of cash UTP would re-

ceive if LTP liquidated immediately after the hypothetical transaction, decreased by \$7,000, the amount of tax gain allocated to UTP from the hypothetical transaction). UTP's share of the adjusted basis to LTP of partnership property is \$18,333 (\$15,000 share of previously taxed capital, plus \$3,333 share

of LTP's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is \$2,100 (\$20,433 minus \$18,333).

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

(c) *Adjustments under section 734(b)*—  
(1) *Allocations between classes of property*—(i) *General rule.* Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

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

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

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

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

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

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

*Example.* (i) A, B, and C form equal partnership PRS. A contributes \$50,000 and Asset 1, nondepreciable capital gain property with a fair market value of \$50,000 and an adjusted tax basis of \$25,000. B and C each contributes

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\$100,000. PRS uses the cash to purchase Assets 2, 3, 4, 5, and 6. Assets 2 and 3 are non-depreciable capital assets, and Assets 4, 5, and 6 are inventory that has not appreciated substantially in value within the meaning of section 751(b)(3). Assets 4, 5, and 6 are the

only assets held by the partnership that are subject to section 751. The partnership has an election in effect under section 754. After seven years, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1 .....	\$ 25,000	\$ 75,000
Asset 2 .....	100,000	117,500
Asset 3 .....	50,000	60,000
Ordinary Income Property:		
Asset 4 .....	40,000	45,000
Asset 5 .....	50,000	60,000
Asset 6 .....	10,000	2,500
Total .....	275,000	360,000

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

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

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

ner to attach a statement to its return showing the computation of a basis adjustment under section 732(d) and the partnership properties to which the adjustment is allocated under section 755. See § 1.732-1(d)(5) for a provision requiring the partnership to provide information to a transferee partner reporting a basis adjustment under section 732(d).

(e) *Effective Date*—(1) *Generally.* Except as provided in paragraphs (b)(5) and (e)(2) of this section, this section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

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

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

DEFINITIONS

§ 1.761-1 Terms defined.

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

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

(c) *Partnership agreement.* For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof