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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–151416–06]

RIN 1545–BG21

Certain Distributions Treated as Sales or Exchanges

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that prescribe how a partner should measure its interest in a partnership's unrealized receivables and inventory items, and that provide guidance regarding the tax consequences of a distribution that causes a reduction in that interest. The proposed regulations take into account statutory changes that have occurred subsequent to the issuance of the existing regulations. The proposed regulations affect partners in partnerships that own unrealized receivables and inventory items and that make a distribution to one or more partners.

DATES: Comments and requests for a public hearing must be received by February 2, 2015.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–151416–06), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC, 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–151416–06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224, or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–151416–06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Allison R. Carmody at (202) 317–5279 or Frank J. Fisher at (202) 317–6850; concerning submissions of comments and requests for hearing, Oluwafunmilayo Taylor at (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE–:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by January 2, 2015.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information required by this proposed regulation is in § 1.751–1(b)(3) and (b)(6), and in § 1.755–1(c)(2)(vi). This information is required for a partnership and certain partners to report the information to the IRS necessary to ensure that the partners of the partnership properly report in accordance with the rules of the proposed regulations the correct amount of ordinary income and/or capital gain upon a distribution of property from the partnership to its partners. The collection of information is necessary to ensure tax compliance.

The likely respondents are business or other for-profit institutions.

Estimated total annual reporting burden: 22,500 hours.

Estimated average annual burden hours per respondent vary from 30 minutes to 2 hours, depending on individual circumstances, with an estimated average of 1 hour.

Estimated number of respondents: 22,500.

Estimated annual frequency of responses: Annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 751(b) of the Internal Revenue Code (the Code). In 1954, Congress enacted section 751 to prevent the use of a partnership to convert potential ordinary income into capital gain. *See* H.R. Rep. No. 1337 at 70 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4097. To that end, section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or part of that partner's interest in the partnership's unrealized receivables and inventory items is considered as an amount realized from the sale or exchange of property other than a capital asset. Further, section 751(b) overrides the nonrecognition provisions of section 731 to the extent a partner receives a distribution from the partnership that causes a shift between the partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items (collectively, the partnership's ''section 751 property'') and the partner's interest in the partnership's other property.

Whether section 751(b) applies depends on the partner's interest in the partnership's section 751 property before and after a distribution. The statute does not define a partner's interest in a partnership's section 751 property, but the legislative history indicates that Congress believed a partner's interest in a partnership's section 751 property equals the partner's rights to income from the partnership's section 751 property:

> The provisions relating to unrealized receivables and appreciated inventory items are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income and on appreciated inventory. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. *The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.*

S. Rep. No. 1622 at 99 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4732. (Emphasis added.)

In 1984, Congress amended section 704(c), making mandatory its application to property contributed to a partnership. While Congress did not specifically address the overlap of section 704(c) and section 751, the Conference Report indicates that the 1984 Congress understood that the section 704(c) amendment would impact other provisions in subchapter K and provides regulatory authority to the Secretary of the Treasury to address those repercussions. *See* H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess., June 23, 1984, reprinted in 1984 U.S.C.C.A.N. 1445, 1545.

The IRS and the Treasury Department first issued regulations implementing section 751 in 1956. Following the changes to section 704(c) making its application mandatory, the IRS and the Treasury Department amended the regulations under section 751(a) to provide generally that a partner's interest in section 751 property is the amount of income or loss from section 751 property that would be allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. (*See* TD 8847, 64 FR 69903, Dec. 15, 1999.) However, the 1956 regulations with respect to section 751(b) remained unchanged.

The examples in the current regulations under section 751(b) determine a partner's interest in section 751 property by reference to the partner's share of the gross value of the partnership's assets (the ''gross value'' approach), not by reference to the partner's share of the unrealized gain or loss in the property. *See,* for example, § 1.751–1(g), *Example 2.* Because the gross value approach focuses on a partner's share of the asset's value rather than the partner's share of the unrealized gain, the examples in the current regulations may be too narrow in some respects, and too broad in others, to carry out the intended purpose of section 751(b). That is, the gross value approach may allow a distribution that reduces a partner's share of the unrealized gain in the partnership's section 751 property without triggering section 751(b), and, conversely, may trigger section 751(b) even if the partner's share of the unrealized gain in the partnership's section 751 property is not reduced. For example, Rev. Rul. 84–102 (84–102 CB 119) provides that deemed distributions under section 752 resulting from shifting allocations of indebtedness may result in the partners' shares of asset gross value changing, even though the partners' shares of unrealized gain associated with section 751 property would not necessarily have changed.

If the distribution results in a shift between the partner's interest in the partnership's section 751 property and the partnership's other property, the current regulations require a deemed asset exchange of both section 751 property and other property between the partner and the partnership to determine the tax consequences of the distribution (the ''asset exchange'' approach). *See,* for example, § 1.751–1(g), *Example 6,* of the current regulations. The asset exchange approach is complex, requiring the partnership and partner to determine the tax consequences of both a deemed distribution of relinquished property and a deemed taxable exchange of that property back to the partnership. The asset exchange approach also often accelerates capital gain unnecessarily by requiring certain partners to recognize capital gain even when their shares of partnership capital gain have not been reduced.

In 2006, the IRS and the Treasury Department published Notice 2006–14 (2006–1 CB 498), which suggested, and requested comments on, alternative approaches to section 751(b) that were intended to better achieve the purpose of the statute while providing greater simplicity. *See* § 601.601(d)(2)(ii)(*b*). Specifically, Notice 2006–14 asked for comments on: (1) Replacing the gross value approach with a ''hypothetical sale'' approach for purposes of determining a partner's interest in the partnership's section 751 property, and (2) replacing the asset exchange approach with a ''hot asset sale'' approach to determine the tax consequences when section 751(b) applies. The hypothetical sale approach and the hot asset sale approach are described in Parts 1.A and 3, respectively, of the Summary of Comments and Explanation of Provisions section of this preamble. Notice 2006–14 also requested comments on other possible approaches to simplifying compliance with section 751(b).

As described in Notice 2006–14, the hypothetical sale approach for section 751(b) is similar to the approach taken in the 1999 regulations issued under section 751(a), shifting the focus to tax gain and away from gross value. Under the hypothetical sale approach, a partner's interest in section 751 property is determined by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property for fair market value immediately before the distribution. More specifically, the hypothetical sale approach applies section 704(c) principles in comparing: (1) The amount of ordinary income that each partner would recognize if the partnership sold all of its property for fair market value immediately before the distribution, with (2) the amount of ordinary income each partner would recognize if the partnership sold all of its property (and the distributee partners sold the distributed assets) for fair market value immediately after the distribution. If the distribution reduces the amount of ordinary income (or increases the amount of ordinary loss) from section 751 property that would be allocated to, or recognized by, a partner (thus reducing that partner's interest in the partnership's section 751 property), the distribution triggers section 751(b).

Notice 2006–14 indicated that changes to the framework of subchapter K since the promulgation of the existing regulations would work in tandem with the hypothetical sale approach to achieve the statute's objective of ensuring that a partner recognizes its proper share of the partnership's income from section 751 property without unnecessarily accelerating the recognition of that income. For example, regulations under section 704(b) allow a partnership to revalue its assets upon a distribution in consideration of a partnership interest. Any revaluation gain or loss is subject to the rules of section 704(c), which generally preserve each partner's share of the unrealized gain and loss in the partnership's assets.

Notice 2006–14 also requested comments on using the hot asset sale approach, rather than the asset exchange approach, to determine the tax consequences of the distribution that is subject to section 751(b). The hot asset sale approach deems the partnership to distribute the relinquished section 751 property to the partner whose interest in the partnership's section 751 property is reduced, and then deems the partner to sell the relinquished section 751 property back to the partnership immediately before the actual distribution.

Summary of Comments and Explanation of Provisions

The IRS and the Treasury Department received both formal and informal responses to Notice 2006–14. In addition, a number of commentators published articles analyzing the proposals outlined in Notice 2006–14. Commentators' responses to Notice 2006–14 were predominantly favorable.

These proposed regulations adopt many of the principles described in Notice 2006–14. Part 1 of this section describes the rules included in the proposed regulations for determining partners' interests in section 751 property. Part 2 of this section sets forth the proposed regulations' test to determine whether section 751(b) applies to a partnership distribution, including anti-abuse principles that may apply in certain situations in which the test would not otherwise be satisfied. Part 3 of this section explains the tax consequences of a section 751(b) distribution under the proposed regulations. Finally, Part 4 of this section describes certain ancillary issues relating to the proposed regulations, including a clarification to the scope of § 1.751–1(a).

1. Determination of a Partner's Interest in Section 751 Property

Section 751(b) applies to a partnership distribution to the extent the distribution reduces a partner's interest in section 751 property. As discussed further in this Part 1, the proposed regulations establish an approach for measuring partners' interests in section 751 property, provide new rules under section 704(c) to help partnerships compute partner gain in section 751 property more precisely, and describe how basis adjustments under sections 734(b) and 743(b) affect the computation of partners' interests in section 751 property.

A. Adoption of Hypothetical Sale Approach

The first step in computing the effect of section 751(b) is to measure the partners' interests in section 751 property. Commentators generally agreed that the hypothetical sale approach is a substantial improvement over the gross value approach in the existing regulations. As described in this preamble, the hypothetical sale approach requires a partnership to compare: (1) The amount of ordinary income (or ordinary loss) that each partner would recognize if the partnership sold its property for fair market value immediately before the distribution with (2) the amount of ordinary income (or ordinary loss) each partner would recognize if the partnership sold its property, and the distributee partner sold the distributed assets, for fair market value immediately after the distribution. The commentators agreed that, when compared against the gross value approach, the hypothetical sale approach is more consistent with Congress's intent in enacting section 751(b), is easier to apply, and reduces the likelihood that section 751(b) would unnecessarily accelerate ordinary income. Accordingly, these proposed regulations adopt the hypothetical sale approach as the method by which the partners must measure their respective interests in section 751 property for the purpose of determining whether a distribution reduces a partner's interest in the partnership's section 751 property. (A distribution that reduces a partner's interest in the partnership's section 751 property is referred to as a "section 751(b) distribution.")

B. Revaluations

Because the hypothetical sale approach relies on the principles of section 704(c) to preserve a partner's share of the unrealized gain and loss in the partnership's section 751 property, these proposed regulations make several changes to the regulations relating to section 704(c). Specifically, the proposed regulations revise § 1.704–1(b)(2)(iv)(*f*), regarding revaluations of partnership property, to make its provisions mandatory if a partnership distributes money or other property to a partner as consideration for an interest in the partnership, and the partnership owns section 751 property immediately after the distribution. (A partnership that does not own section 751 property immediately after the distribution may still revalue its property under the existing regulation, but is not required to do so under these proposed regulations.) If a partnership does not maintain capital accounts in accordance with § 1.704–1(b)(2)(iv), the partnership must comply with this requirement by computing each partner's share of gain or loss in each partnership asset prior to a distribution, and making future allocations of partnership items in a manner that takes these amounts into account (making subsequent adjustments for cost recovery and other events that affect the property basis of each such asset).

In addition, the proposed regulations contain a special revaluation rule for distributing partnerships that own an interest in a lower-tier partnership. Because a partnership's section 751 property includes, under section 751(f), the partnership's proportionate share of section 751 property owned by any other partnership in which the distributing partnership is a partner, these proposed regulations also require a partnership in which the distributing partnership owns a controlling interest (which is defined as a greater than 50 percent interest) to revalue its property if the lower-tier partnership owns section 751 property immediately after the distribution. If the distributing partnership owns a non-controlling (that is, less than or equal to 50 percent) interest in a lower-tier partnership, these proposed regulations require the distributing partnership to allocate its distributive share of the lower-tier partnership's items among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its partnership property. The IRS and the Treasury Department are aware that in some instances a distributing partnership may be unable to obtain sufficient information to comply with this requirement from a lower-tier partnership in which the distributing partnership holds a non-controlling interest. We request comments on reasonable approaches to address this issue.

Upon the revaluation of partnership property in connection with a partnership distribution, the regulations under section 704(c) permit a partnership to choose any reasonable method to account for the built-in gain or built-in loss that is consistent with the purpose of section 704(c). If property with built-in gain decreases in value (or property with built-in loss increases in value), then the partnership may be unable to allocate tax losses (or gains) to a non-contributing partner in an amount equal to the partner's economic loss (or gain). If the property with built-in gain (or loss) is section 751 property, then the inability to allocate those tax losses (or gains) may cause ordinary income to shift among the partners. The regulations under section 704(c) provide two reasonable methods for a partnership to allocate items to cure or remediate that shift. However, the regulations under section 704(c) also provide a third reasonable method, the traditional method, under which the shift of ordinary income is not cured. The IRS and the Treasury Department are aware that distortions created under the section 704(c) traditional method may cause ordinary income to shift among partners. However, the regulations under section 704(c) contain an anti-abuse rule that provides that a method is not reasonable if, for example, the event that results in a reverse section 704(c) allocation and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or built-in loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. The IRS and the Treasury Department believe that this anti-abuse provision under section 704(c) properly addresses the possibility that taxpayers would use the traditional method to shift ordinary income.

Some commentators suggested changing the regulations under section 704(c) to minimize the situations in which section 751(b) applies. Generally, when a partnership revalues its assets, the partnership allocates a reverse section 704(c) amount with respect to each partnership asset, as opposed to an aggregate section 704(c) amount with respect to all assets (subject to certain exceptions). As a result, any distribution of appreciated section 751 property in which another partner has a share of income would trigger section 751(b) under the hypothetical sale approach. The commentators recommended that the IRS and the Treasury Department narrow the application of section 751(b) by allowing partners (subject to the substantiality requirements of § 1.704–1(b)(2)(iii)) to ''exchange'' reverse section 704(c) amounts resulting from a section 751 distribution. These proposed regulations do not adopt this comment because it is beyond the scope of these regulations and would impact other provisions of subchapter K. However, the IRS and the Treasury Department believe that the issue merits further study and request comments on how such permissible exchanges of reverse section 704(c) amounts might be addressed in future regulations.

C. Effect of Basis Adjustments on Section 751(b) Computations

While section 704(c) revaluations generally preserve partners' interests in section 751 property upon a partnership distribution, certain basis adjustments under sections 732(c) or 734(b) may alter partners' interests in section 751 property following the distribution. Accordingly, these proposed regulations provide rules on the effect of these basis adjustments on the computation of partners' interests in section 751 property.

If a distribution of capital gain property results in a basis adjustment under section 734(b), that basis adjustment is allocated to capital gain property of the partnership under § 1.755–1(c)(1). However, some property that is characterized as capital gain property for purposes of section 755 can also result in ordinary income when sold. For example, section 1231 property is characterized as a capital asset for purposes of section 755, but selling the property can also result in ordinary income from recapture under section 1245(a)(1). The regulations under section 755 do not differentiate between the capital gain aspect of the property and the ordinary income aspect of the property for this purpose. Accordingly, allocating a section 734(b) positive basis adjustment to such property as capital gain property may reduce the amount of ordinary income that would result on a sale of the property. Under these proposed regulations, that reduction in ordinary income would constitute a reduction in the partners' shares of unrealized gain in the partnership's section 751 property, which could trigger section 751(b) in situations in which 751(b) would not have otherwise applied. A similar reduction in section 751 property could occur if the basis of the distributed property increases under section 732.

One commentator recommended allowing partnerships to avoid this result by eliminating a positive section 734(b) adjustment to the extent the section 734(b) adjustment would reduce the partnership's ordinary income. Another commentator recommended allocating the section 734(b) adjustment to other partnership capital gain property. The same commentator alternatively recommended treating a positive section 734(b) adjustment that reduced the partnership's ordinary income as a separate asset.

Although these proposed regulations do not treat the section 734(b) adjustment as a separate asset, the proposed regulations reach a similar result to this last recommendation. They provide that a basis adjustment under section 732(c) or section 734(b) (as adjusted for recovery of the basis adjustment) that is allocated to capital gain property and that reduces the ordinary income (attributable, for example, to recapture under section 1245(a)(1)) that the partner or partnership would recognize on a taxable disposition of the property is not taken into account in determining (1) the partnership's basis for purposes of sections 617(d)(1), 1245(a)(1), 1250(a)(1), 1252(a)(1), and 1254(a)(1), and (2) the partner or partnership's respective gain or loss for purposes of sections 995(c), 1231(a), and 1248(a). The IRS and the Treasury Department intend for these amendments to apply for purposes of other provisions that cross-reference those sections (for example, the reference in § 1.367(b)–2(c) to section 1248). The IRS and the Treasury Department are aware that these rules may result in additional administrative burden and, therefore, permit a partnership and its partners to elect to recognize ordinary income currently under section 751(b) in lieu of applying these rules.

In addition, one commentator raised questions about the application of section 751(b) upon the distribution to a partner of section 751 property for which another partner has a basis adjustment under section 743(b) (the transferee partner). The commentator questioned whether the distributee partner's share of section 751 property could be increased inappropriately if the special basis adjustment is not taken into account in determining the distributee's basis in the section 751 property under section 732. The IRS and the Treasury Department believe that although the distributee partner does not take the section 743(b) basis adjustment into account in determining its basis in the distributed property, the reallocation of the section 743(b) basis adjustment pursuant to § 1.743–1(g)(2)(ii) should generally reduce the transferee partner's share of section 751 property, triggering an income inclusion to that partner under section 751(b) which is offset by the basis adjustment. The IRS and the Treasury Department acknowledge that, in situations in which the partnership holds no other section 751 property (and the section 743(b) basis adjustment is temporarily suspended under §§ 1.743–1(g)(2)(ii) and 1.755–1(c)(4) until the partnership acquires additional ordinary income property), the application of section 751(b) may be unclear. Accordingly, the proposed regulations require that partners include the effect of carryover basis adjustments when determining their shares of section 751 property, as though those basis adjustments were immediately allocable to ordinary income property. *See Example 4* in § 1.751–1(g) of the proposed regulations.

2. Distributions to Which Section 751(b) Applies

A. General Principle

The purpose of section 751 is to prevent a partner from converting its share of potential ordinary income into capital gain. A distribution of partnership property (including money) is a section 751(b) distribution if the distribution reduces any partner's share of net section 751 unrealized gain or increases any partner's share of net section 751 unrealized loss (as determined under the hypothetical sale approach described in Part 1.A of the Summary of Comments and Explanation of Provisions section of this preamble). For this purpose, a partner's net section 751 unrealized gain or loss immediately before a distribution equals the amount of net gain or loss, as the case may be, from section 751 property that would be allocated to the partner if the partnership disposed of all of the partnership's assets for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)). A partner's net section 751 unrealized gain or loss includes any remedial allocations under § 1.704–3(d).

A partner's net section 751 unrealized gain or loss also takes into account any section 743 basis adjustment pursuant to § 1.743–1(j)(3), including any carryover basis adjustment that results under any of § 1.743–1(g)(2)(ii), § 1.755–1(b)(5)(iii)(D), or § 1.755–1(c)(4) when the partnership must adjust the basis of a specific class of assets, but that adjustment is suspended because the partnership does not own assets in that class. The regulations take such suspended basis adjustments into account as though the basis adjustment is applied to the basis of notional partnership section 751 property with a fair market value of zero. For example, if A and B are partners in the AB partnership, which owns capital assets and a single ordinary income asset that is the subject of a section 743(b) adjustment with respect to B, and that asset is distributed to partner A, B's basis adjustment is suspended because the partnership lacks other ordinary income property. However, the basis adjustment will eventually benefit B when the partnership acquires new ordinary income property. For this reason, the proposed regulations require B to take the suspended adjustment into account when determining whether section 751(b) applies to B with respect to the distribution.

A partner's share of net section 751 unrealized gain or loss from section 751 property immediately following a distribution is computed using the same formula. However, the distributee partner also includes in its post-distribution amount its share of net income or loss from a hypothetical sale of the distributed section 751 property.

If section 751(b) applies to a distribution, each partner must generally recognize or take into account currently ordinary income equal to its ''section 751(b) amount.'' If a partner has net section 751 unrealized gain both before and after the distribution, then the partner's section 751(b) amount equals the partner's net section 751 unrealized gain immediately before the distribution less the partner's net section 751 unrealized gain immediately after the distribution. If a partner has net section 751 unrealized loss both before and after the distribution, then the partner's section 751(b) amount equals the partner's net section 751 unrealized loss immediately after the distribution less the partner's net section 751 unrealized loss immediately before the distribution. If a partner has net section 751 unrealized gain before the distribution and net section 751 unrealized loss after the distribution, then the partner's section 751(b) amount equals the sum of the partner's net section 751 unrealized gain immediately before the distribution and the partner's net section 751 unrealized loss immediately after the distribution.

Commentators requested a de minimis exception to section 751(b). The IRS and the Treasury Department continue to study the issue and request comments describing the parameters of a de minimis rule that would be helpful.

B. Section 751 Anti-Abuse Rule

The IRS and the Treasury Department believe that, despite the general principle that section 751(b) should apply only at the time that a partner's share of net section 751 unrealized gain is reduced (or net section 751 loss is increased), the deferral of ordinary income upon the receipt of a distribution is inappropriate in certain circumstances. Specifically, deferral is inappropriate if a partner engages in a transaction that relies on the rules of section 704(c) to defer or eliminate ordinary income while monetizing most of the value of the partnership interest. Accordingly, these proposed regulations provide an anti-abuse rule that requires taxpayers to apply the rules set forth in the proposed regulations in a manner consistent with the purpose of section 751, and that allows the Commissioner to recast transactions for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 751.

The proposed regulations provide a list of situations that are presumed inconsistent with the purpose of section 751. Under this list, a distribution is presumed inconsistent with the purpose of section 751 if section 751(b) would apply but for the application of section 704(c) principles, and one or more of the following conditions exists: (1) A partner's interest in net section 751 unrealized gain is at least four times greater than the partner's capital account immediately after the distribution, (2) a distribution reduces a partner's interest to such an extent that the partner has little or no exposure to partnership losses and does not meaningfully participate in partnership profits aside from a preferred return for the use of capital, (3) the net value of the partner (or its successor) becomes less than its potential tax liability from section 751 property as a result of a transaction, (4) a partner transfers a portion of its partnership interest within five years after the distribution to a tax-indifferent party in a manner that would not trigger ordinary income recognition in the absence of this anti-abuse rule, or (5) a partnership transfers to a corporation in a nonrecognition transaction section 751 property other than pursuant to a transfer of all property used in a trade or business (excluding assets that are not material to a continuation of the trade or business). In addition, the proposed regulations provide that an amendment to the partnership agreement that results in a reduction in a partner's interest in section 751 property is also presumed inconsistent with the purpose of section 751. A partnership or a partner taking a position on its return that section 751 does not apply to a transaction that meets one or more of these situations must disclose its position on Form 8275, Disclosure Statement.

3. Tax Consequences of a Section 751(b) Distribution

If section 751(b) applies to a distribution under the principles set forth in Part 2 of the Summary of Comments and Explanation of Provisions section of this preamble, then the partners must determine the consequences of its application to the partnership and its partners. As described in the Background section of this preamble, Notice 2006–14 discussed replacing the asset exchange approach with a hot asset sale approach to determine these consequences. While most commentators agreed that the hot asset sale approach is an improvement over the existing regulations' asset exchange approach, commentators were able to identify situations in which the hot asset sale approach fails to achieve the correct result or causes undesirable results under other Code provisions. Two commentators advocated adopting, in lieu of the hot asset sale approach, an approach similar to that taken in section 704(c)(1)(B) (referred to in this preamble as a ''deemed gain'' approach), in which a section 751(b) distribution results in: (1) The partnership recognizing ordinary income in the aggregate amount of each partner's reduction in the partner's interest in section 751 property, (2) the partnership allocating ordinary income to the partner or partners whose interest in section 751(b) property was reduced by the distribution, and (3) the partnership making appropriate basis adjustments to its assets to reflect its ordinary income recognition. One variation of the deemed gain approach would require capital gain recognition in certain cases.

The IRS and the Treasury Department determined that a deemed gain approach produces an appropriate outcome in the greatest number of circumstances out of the approaches under consideration, and that the hot asset sale approach also produced an appropriate outcome in most circumstances. However, no one approach produced an appropriate outcome in all circumstances. Therefore, these proposed regulations withdraw the asset exchange approach of the current regulations, but do not require the use of a particular approach for determining the tax consequences of a section 751(b) distribution. Instead, these proposed regulations provide that if, under the hypothetical sale approach, a distribution reduces a partner's interest in the partnership's section 751 property, giving rise to a section 751(b) amount, then the partnership must use a reasonable approach that is consistent with the purpose of section 751(b) to determine the tax consequences of the reduction. Except in limited situations, a partnership must continue to use the same approach, once chosen, including after a termination of the partnership under section 708(b)(1)(B). These proposed regulations include examples in which the approach adopted is generally reasonable based on the facts of the examples, and one example in which it is determined that the adopted approach is not reasonable based on the facts of the example.

Finally, some commentators recommended allowing taxpayers to elect to recognize capital gain in certain situations (for example, in the situation described in *Example 2* in Notice 2006–14 involving distributions of section 751(b) property to a partner that has insufficient basis in its partnership interest to absorb fully the partnership's basis in the distributed property). Recognition of gain may be appropriate where failing to recognize gain would cause an adjustment to the basis of distributed property (under section 732) or to the basis of partnership property (under section 734(b)) if those basis adjustments would change the partners' shares of ordinary income already determined under the principles described in Part 1 of the Summary of Comments and Explanation of Provisions section of this preamble. Such changes in ordinary income amounts could (in the case of certain adjustments under section 734(b)) decrease partners' shares of partnership ordinary income, requiring the recognition of additional income under section 751(b), or could (in the case of certain adjustments under section 732) convert a distributee partner's share of capital gain into ordinary income. Thus, these proposed regulations require that distributee partners recognize capital gain in certain situations, and permit distributee partners to elect to recognize capital gain in certain other situations.

The proposed regulations require a distributee partner to recognize capital gain to the extent necessary to prevent the distribution from triggering a basis adjustment under section 734(b) that would reduce other partners' shares of net unrealized section 751 gain or loss. Capital gain recognition is necessary in this situation because the section 734(b) basis adjustment was not taken into account in determining the partners' net section 751 unrealized gain or loss immediately after the section 751 distribution, and the IRS and the Treasury Department believe that an approach under which a partnership redetermines a partner's net section 751 unrealized gain or loss to account for section 734(b) basis adjustments would be both administratively burdensome and would accelerate ordinary income unnecessarily. *See Examples 5* and *6* in § 1.751–1(g) of the proposed regulations. Gain recognized in this event is generally capital; however, if the partnership makes an election under § 1.755–1(c)(2)(vi), then the partner must characterize all or a portion of the gain recognized under this rule as ordinary income or a dividend, as appropriate, to preserve the character of the gain in the adjusted asset. *See Example 9* in § 1.751–1(g) of the proposed regulations.

These proposed regulations also allow distributee partners to elect to recognize capital gain in certain circumstances to avoid decreases to the basis of distributed section 751 property. Elective capital gain recognition is appropriate to eliminate a negative section 732(a)(2) or (b) basis adjustment to the asset or assets received in distribution if, and to the extent that, the distributee partner's net section 751 unrealized gain would otherwise be greater immediately after the distribution than it was immediately before the distribution (or would cause the distributee partner's net section 751 unrealized loss to be less immediately after the distribution than it was immediately before the distribution). For example, elective capital gain recognition is appropriate if a partner with zero basis in its partnership interest receives a distribution of partnership section 751 property with basis in the hands of the partnership equal to its value, and the distribution otherwise increases the distributee partner's net section 751 unrealized gain.

4. Miscellaneous

A. Section 751(a)

As described in Parts 2.A and 2.B of this preamble, these proposed regulations generally defer the recognition of ordinary income upon a distribution when the partner's unrealized gain and loss in the partnership's section 751 property is preserved through the application of the principles of section 704(c). This approach is consistent with the 1984 amendment to section 704(c). By mandating the application of section 704(c) principles, that amendment partially severed the relationship that had generally existed between a partner's distributive share (that is, the right to share in the economic gain or loss) associated with a partnership item and the partner's share of tax gain or loss from the sale of that item. The IRS and the Treasury Department believe that, by mandating the application of section 704(c) principles in 1984, Congress intended that impacted provisions be interpreted consistent with this new emphasis on tax gain or loss. Congress provided a broad delegation of authority to the Treasury Department to address these repercussions of amending section 704(c) on other provisions in subchapter K.

Some commentators interpret section 751(a) as limiting the amount of ordinary income that a transferor partner may recognize upon a transfer of a partnership interest to the amount of any money or property received by the transferor partner, without taking into account the total amount of ordinary income attributable to the partnership interest transferred that relates to section 751 property. However, interpreting section 751(a) as limiting ordinary income in this way would contravene Congress's intent to tax partners on their shares of partnership ordinary income as determined by applying section 704(c) principles. The IRS and the Treasury Department believe that section 751(a) should be interpreted in a manner that accounts for the impact of section 704(c). Thus, these proposed regulations provide that the amount of money or the fair market value of property received for purposes of section 751(a) takes into account the transferor partner's share of income or gain from section 751 property.

The IRS and the Treasury Department alternatively considered addressing this issue by deeming a partner that sells or exchanges its partnership interest to receive a distribution of the partner's share of the section 751 property, followed by a sale of the property back to the partnership for its fair market value, recognizing the deferred ordinary income inherent in the section 751 property. The partner would then be deemed to contribute the cash proceeds to the partnership thereby increasing the partner's basis in the partner's partnership interest. Finally, upon the sale or exchange of the partnership interest, the partner would recognize the appropriate amount of capital loss. This potential multi-step deemed approach would result in additional complexity and would reach the same result that the current regulations under § 1.751–1(a) reach as clarified by these proposed regulations. Therefore, the IRS and the Treasury Department are not proposing this alternative approach.

B. Previously Contributed Property Exception

Section 751(b)(2)(A) provides that section 751(b) does not apply to a distribution of property that the distributee contributed to the partnership (''previously contributed property exception''). Unlike other provisions in subchapter K that include similar previously contributed property exceptions, the current regulations under section 751(b) do not contain successor rules for purposes of applying the section 751(b) previously contributed property exception. These proposed regulations add successor rules to section 751(b) similar to the successor rules contained in other previously contributed property exceptions within subchapter K.

C. Mergers and Divisions

A commentator requested guidance confirming how the rules of section 751(b) apply in the case of an incorporation, merger, or division of a partnership. The proposed regulations do not adopt this comment because the IRS and the Treasury Department believe such guidance is beyond the scope of these proposed regulations.

D. Substantial Appreciation Test

These proposed regulations also make a number of technical corrections to account for changes in the law since the issuance of existing regulations under section 751. For example, these proposed regulations remove the language ''substantially appreciated'' from the first sentence of § 1.751–1(a)(1), which applies with respect to sales or exchanges of an interest in a partnership. In addition to conforming the language of the regulations to that of the Code, this change is intended to clarify that, upon a sale or exchange of a partnership interest, unrealized receivables and inventory items are treated in the same manner. Thus, a transferor partner may recognize an ordinary loss with respect to inventory items pursuant to section 751(a) to the extent the transferor would be allocated a net ordinary loss pursuant to § 1.751–1(a)(2). These proposed regulations also update the definition of ''inventory items which have appreciated substantially in value'' with respect to section 751(b) to reflect the 1993 amendment to the statute that eliminated the 10-percent test from the definition of ''*substantial appreciation.'' See* Public Law 103–66, Sec. 13206(e)(1). These proposed regulations also clarify that unrealized receivables are not included in the term ''inventory items which have appreciated substantially in value.''

E. Other Changes Relating to Revaluations

Finally, these proposed regulations address some of the comments received in response to Notice 2009–70 (2009–2 CB 255), in which the IRS and the Treasury Department requested comments on, among other things, whether additional events should be added to the list of events permitting a revaluation of partnership property pursuant to § 1.704–1(b)(2)(iv)(*f*) and whether, in a tiered partnership structure, a revaluation at one partnership in the tier should permit another partnership in the tier to revalue that partnership's property. Commentators recommended that partnership recapitalizations (changes to the way partners agree to share partnership profits and losses) be added as a permissible revaluation event. The IRS and the Treasury Department agree that partnership recapitalizations should be added as a permissible event because, absent providing for a special allocation of any unrealized gain or loss in partnership assets that arose prior to the recapitalization, a revaluation is necessary to preserve each partner's share of such unrealized amounts. In addition, commentators recommended that a partnership in a tiered partnership structure be able to revalue its partnership property if another partnership in the tiered structure was permitted to revalue its partnership property. The IRS and the Treasury Department agree and believe that permitting successive revaluations in a tiered partnership structure is necessary to properly allocate items with respect to a reverse section 704(c) allocation to the appropriate partner.

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Effect on Other Documents

The following publication will be obsolete as of the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**:

Rev. Rul. 84–102 (1984–2 CB 119).

Proposed Effective/Applicability Date

The regulations, as proposed, apply to distributions occurring in any taxable period ending on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. The rules contained in § 1.751–1(a)(2) would apply to transfers of partnership interests that occur on or after November 3, 2014. However, the rules contained in § 1.751–1(a)(2) are a clarification of existing rules, and no inference is intended from the change to § 1.751–1(a)(2) with respect to sales or exchanges of partnership interests prior to the effective date for § 1.751–1(a)(2). The rules contained in § 1.751–1(a)(3) continue to apply to transfers of partnership interests that occur on or after December 15, 1999. A partnership and its partners would be able to rely on § 1.751–1(b)(2) of these proposed regulations for purposes of determining a partner's interest in the partnership's section 751 property on or after November 3, 2014 provided the partnership and its partners apply each of § 1.751–1(a)(2), § 1.751–1(b)(2), and § 1.751–1(b)(4) of these proposed regulations consistently for all partnership distributions and sales or exchanges, including for any distributions and sales or exchanges the partnership makes after a termination of the partnership under section 708(b)(1)(B).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13653. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to prepare the required disclosure is not lengthy and few small businesses are likely to be partners or partnerships required to make the disclosures required by the rule. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

The IRS and the Treasury Department request comments on all aspects of the proposed rules. In particular, the IRS and the Treasury Department request comments, in addition to those previously requested in this preamble, on: (1) Whether and how carryover adjustments to ordinary income property under sections 734(b) and 743(b) should be taken into account under the hypothetical sale approach, (2) whether the final regulations should exclude certain types of transactions from the previously contributed property successor rules provided in these proposed regulations, (3) whether the regulations should specifically describe approaches as generally reasonable approaches for determining the tax consequences of a section 751(b) distribution, and which approaches should be specified as generally reasonable, (4) whether the final regulations should provide rules similar to those proposed in new § 1.755–1(c)(2)(iii) through (vi) in § 1.755–1(b)(5) with respect to section 743(b) adjustments in substituted basis transactions, and (5) what disclosures the IRS and the Treasury Department should require from partners and partnerships that either recognize gain under section 751(a) or (b), or rely on reverse section 704(c) allocations to defer the gain recognition required by section 751(a) or (b).

The IRS and the Treasury Department also request comments on a topic that, although not specific to section 751, may impact the rules under section 751. The IRS and the Treasury Department are aware that the regulations under § 1.1245–1(e)(3) (concerning the interaction of section 1245 and section 743), and § 1.1250–1(f), by reference to § 1.1245–1(e)(3), are out of date. The intent of the regulations under § 1.1245–1(e)(3) is, in part, to ensure that a transferee partner does not recognize ordinary income with respect to section 1245 property to the extent a section 743 adjustment has displaced that ordinary income. For example, if a partner sells in a fully taxable exchange its interest in a partnership that has elected under section 754, and the selling partner recognizes ordinary income under section 751(a) with respect to partnership section 1245 property, then the rules under sections 1245 and 743 are intended to ensure that the transferee partner recognizes no ordinary income on an immediately subsequent disposition of the section 1245 property in a fully taxable transaction. However, the regulations under § 1.1245–1(e)(3) have not been amended to take into account changes to subchapter K, including the regulations under section 751, resulting in issues and uncertainties. The IRS and the Treasury Department are studying these issues and request comments in this area.

Finally, the IRS and the Treasury Department request comments as to how section 751(b) should interact with rules for withholding and reporting with respect to nonresident aliens and foreign corporations. For example, the IRS and the Treasury Department are considering whether regulations should provide that for purposes of withholding under chapter 3 of Subtitle A (for example, under section 1446), income recognized as a result of a section 751(b) distribution is treated as recognized by the partnership regardless of the approach chosen to determine the U.S. tax consequences of the section 751(b) distribution. The IRS and the Treasury Department are also considering whether additional guidance with respect to tax or information returns (for example, pursuant to section 6031(b) or section 6050K) is necessary for gain recognized on section 751(b) distributions affecting these taxpayers.

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the ''Addresses'' heading. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person who submits timely written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Allison R. Carmody and Frank J. Fisher, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.617–4 is amended by adding a new sentence at the end of paragraph (c)(3)(ii)(*g*) to read as follows:

§ 1.617–4 Treatment of gain from disposition of certain mining property.

* * * * *

(c) * * *

(3) * * *

(ii) * * *

(*g*) * * * *See also* §§ 1.732–1(c)(2)(iii) and 1.755–1(c)(2)(iii) for rules governing the application of section 617 to partnership property in certain situations.

* * * * *

■ **Par. 3.** Section 1.704–1 is amended by:

■ a. Revising paragraph (b)(2)(iv)(*f*) introductory text.
■ b. Redesignating paragraph (b)(2)(iv)(*f*)(*5*)(*v*) as paragraph (b)(2)(iv)(*f*)(*5*)(*vi*).
■ c. Adding new paragraph (b)(2)(iv)(*f*)(*5*)(*v*).
■ d. Designating the undesignated text after paragraph (b)(2)(iv)(*f*)(*5*)(*vi*) as paragraph (b)(2)(iv)(*f*)(*5*)(*vii*).

The revisions and additions read as follows:

§ 1.704–1 Partner's distributive share.

* * * * *

(b) * * *

(2) * * *

(iv) * * *

(*f*) *Revaluations of property.* A partnership agreement may, upon the occurrence of certain events, and must in the circumstances described in § 1.751–1(b)(2)(iv), increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. If a partnership that revalues its property pursuant to this paragraph owns an interest in another partnership, that partnership in which it owns an interest may also revalue its property in accordance with this section. Similarly, if an interest in a partnership that revalues its property pursuant to this paragraph is owned by another partnership, the partnership owning that interest may also revalue its property in accordance with this section. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

* * * * *

(5) * * *

(v) In connection with an agreement to change (other than a de minimis change) the manner in which the partners share any item or class of items of income, gain, loss, deduction or credit of the partnership under the partnership agreement, or

* * * * *

■ **Par. 4.** Section 1.704–3 is amended in paragraph (a)(9) by adding a sentence immediately following the first sentence to read as follows:

§ 1.704–3 Contributed property.

(a) * * *

(9) * * * If a partnership (the upper-tier partnership) owns an interest in another partnership (the lower-tier partnership), and both the upper-tier partnership and the lower-tier partnership simultaneously revalue partnership property pursuant to § 1.704–1(b)(2)(iv)(*f*), the principles of this paragraph (a)(9) shall apply to any reverse section 704(c) allocations created upon the revaluation. * * *

* * * * *

■ **Par. 5.** Section 1.732–1 is amended by adding paragraphs (c)(2)(iii), (iv), (v), (vi), and (vii), and revising paragraph (c)(5) to read as follows:

§ 1.732–1 Basis of distributed property other than money.

* * * * *

(c) * * *

(2) * * *

(iii) *Property subject to section 1245.* Any increase in basis allocated to capital gain property pursuant to the second sentence in paragraph (c)(2)(ii) of this section is not taken into account in determining the recomputed or adjusted basis in the property for purposes of section 1245(a)(1). Notwithstanding the prior sentence, any depreciation or amortization of the increase in basis that is allowed or allowable is taken into account in computing the property's recomputed basis. In the case of property that is subject to section 617(d)(1), section 1250(a)(1), section 1252(a)(1), or section 1254(a)(1), rules similar to the rule in this paragraph (c)(2)(iii) shall apply. *See Examples 2* and *3* in § 1.755–1(c)(6).

(iv) *Section 1231 property.* Any increase in basis allocated to capital gain property pursuant to the second sentence in paragraph (c)(2)(ii) of this section is not taken into account in determining section 1231 gain and loss, as defined in section 1231(a)(3). *See Examples 2* and *3* in § 1.755–1(c)(6).

(v) *Property subject to section 1248.* Any increase in basis allocated to stock in a foreign corporation pursuant to the second sentence in paragraph (c)(2)(ii) of this section or any decrease in basis allocated to stock in a foreign corporation pursuant to the second sentence in paragraph (c)(2)(i) of this section is not taken into account in determining the amount of gain recognized on the sale or exchange of such stock for purposes of section 1248(a). In the case of property that is subject to section 995(c), rules similar to the rule set forth in this paragraph (c)(2)(v) shall apply. *See Examples 8* and *9* in § 1.751–1(g).

(vi) *Special rule.* Any basis adjustment to an asset that is not taken into account under paragraph (c)(2)(iii), (iv), or (v) of this section shall, upon a taxable disposition, be treated as gain or loss, as the case may be, from the sale or exchange of a capital asset with the same holding period as the underlying asset. *See Examples 2* and *3* in § 1.755–1(c)(6).

(vii) *Election not to apply the provisions of paragraphs (c)(2)(iii), (iv), and (v). See* § 1.755–1(c)(2)(vi) for rules regarding an election to have the provisions of paragraphs (c)(2)(iii), (iv), and (v) of this section, and § 1.755–1(c)(2)(iii), (iv), and (v) not apply. *See Examples 2* and *3* in § 1.755–1(c)(6).

* * * * *

(5) *Effective/applicability date.* This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999, except that paragraphs (c)(2)(iii), (iv), (v), (vi), and (vii) of this section apply to distributions of property from a partnership that occur on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

§ 1.736–1 [Amended]

■ **Par. 6.** Section 1.736–1 is amended in paragraph (b)(4) by removing the language ''paragraph (b)(3)(iii)'' from the last sentence and adding the language ''paragraph (b)(3)'' in its place.

■ **Par. 7.** Section 1.751–1 is amended by:
■ a. Revising paragraphs (a)(1) and (2).
■ b. Revising the first sentence of paragraph (b)(1)(i) and adding a new sentence at the end of paragraph (b)(1)(i).
■ c. Removing the last four sentences of paragraph (b)(1)(ii).
■ d. Revising paragraphs (b)(1)(iii) and (b)(2) and (3).
■ e. Redesignating paragraphs (b)(4) and (5) as paragraphs (b)(5) and (6).
■ f. Adding a new paragraph (b)(4).
■ g. Revising the paragraph heading of newly designated paragraph (b)(5).
■ h. Further redesignating newly redesignated paragraph (b)(5)(ii) as paragraph (b)(5)(vi) and adding paragraphs (b)(5)(ii), (iii), (iv), and (v).
■ i. Revising newly designated paragraph (b)(6).
■ j. Revising paragraph (c)(4)(vi).
■ k. Adding paragraph (c)(4)(x).
■ l. Removing paragraphs (c)(5) and (6).
■ m. Revising the first and second sentences of paragraph (d)(1).
■ n. Revising paragraphs (e), (f), and (g).

The additions and revisions read as follows:

§ 1.751–1 Unrealized receivables and inventory items.

(a) * * * (1) *Character of amount realized.* To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of ''unrealized receivables'' and ''inventory items,'' see section 751(c) and (d). *See* paragraph (e) of this section for the definition of section 751 property.

(2) *Determination of gain or loss.* The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (taking into account allocations of tax items applying the principles of section 704(c), including any remedial allocations under § 1.704–3(d), and any section 743 basis adjustment pursuant to § 1.743–1(j)(3)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest. For purposes of section 751(a) and paragraph (a) of this section, the amount of money or the fair market value of property received by the partner in exchange for all or part of his partnership interest must take into account the partner's share of income or gain from section 751 property. *See Example 1* in paragraph (g) of this section. *See* § 1.460–4(k)(2)(iv)(E) for rules relating to the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting.

* * * * *

(b) *Certain distributions treated as sales or exchanges*—(1) *In general.* (i) Certain distributions to which section 751(b) applies are treated in whole or in part as sales or exchanges of property, and not as distributions to which sections 731 through 736 apply. * * * For purposes of section 751 and this section, a partner's interest in the partnership's section 751 property includes allocations of tax items applying the principles of section 704(c).

* * * * *

(iii) If a distribution is a section 751(b) distribution, as described in paragraph (b)(2)(i) of this section, the tax consequences of the section 751(b) distribution, as determined under paragraph (b)(3) of this section, shall first apply, and then the rules of sections 731 through 736 shall apply. *See* paragraph (b)(5)(vi) of this section for treatment of payments under section 736(a).

(2) *Distributions to which section 751(b) applies*—(i) *Section 751(b) amount.* A distribution is a section 751(b) distribution if it gives rise to a ''section 751(b) amount'' for any partner. A partner's section 751(b) amount (if any) associated with a distribution of partnership property (including money) equals the greatest of—

(A) The amount by which the partner's net section 751 unrealized gain immediately before the distribution exceeds the partner's net section 751 unrealized gain immediately after the distribution;

(B) The amount by which the partner's net section 751 unrealized loss immediately after the distribution exceeds the partner's net section 751 unrealized loss immediately before the distribution; and

(C) The amount of the partner's net section 751 unrealized gain immediately before the distribution, increased by the total amount of the partner's net section 751 unrealized loss immediately after the distribution (where neither of those numbers equals zero).

(ii) *Net section 751 unrealized gain or loss before a distribution.* A partner's net section 751 unrealized gain or loss immediately before a distribution equals the amount of net income or loss, as the case may be, from section 751 property that would be allocated to the partner if the partnership disposed of all of the partnership's assets for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)). For this purpose, a partner's net section 751 unrealized gain or loss includes any remedial allocations under § 1.704–3(d), and takes into account any section 743 basis adjustment pursuant to § 1.743–1(j)(3) and any carryover basis adjustment described in §§ 1.743–1(g)(2)(ii), 1.755–1(b)(5)(iii)(D), or 1.755–1(c)(4) as though the carryover basis adjustment was applied to the basis of new partnership section 751 property with fair market value of zero.

(iii) *Net section 751 unrealized gain or loss after a distribution.* A partner's net section 751 unrealized gain or loss immediately after a distribution equals the sum of (to the extent applicable)—

(A) With respect to a partner remaining in the partnership immediately after the distribution (including a distributee partner remaining in the partnership), the amount of net income or loss, as the case may be (including any remedial allocations under § 1.704–3(d) and taking into account any section 743 basis adjustment pursuant to § 1.743–1(j)(3) and any carryover basis adjustment described in §§ 1.743–1(g)(2)(ii), 1.755–1(b)(5)(iii)(D), or 1.755–1(c)(4) as though the carryover basis adjustment was applied to the basis of new partnership section 751 property with fair market value of zero), from section 751 property that would be allocated to the partner if the partnership disposed of all of the partnership's assets for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)); and

(B) With respect to a partner receiving a distribution, the amount of net income or loss, as the case may be, from section 751 property that would be recognized by the distributee if, immediately after the distribution, the distributee disposed of the distributed assets for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)).

(iv) *Revaluation of assets.* For a partnership that distributes money or property (other than a de minimis amount) to a partner as consideration for an interest in the partnership, and that owns section 751 property immediately after the distribution, if the partnership maintains capital accounts in accordance with § 1.704–1(b)(2)(iv), the partnership must revalue its assets immediately prior to the distribution in accordance with § 1.704–1(b)(2)(iv)(*f*). If a partnership does not maintain capital accounts in accordance with § 1.704–1(b)(2)(iv), the partnership must comply with this section by computing its partners' shares of partnership gain or loss immediately before the distribution as if the partnership assets were sold for cash in a fully taxable transaction (taking into account section 7701(g)), and by taking those computed shares of gain or loss into account under the principles of section 704(c) (making subsequent adjustments for cost recovery and other events that affect the basis of the property). In addition, if the partnership (upper-tier partnership) owns another partnership directly or indirectly through one or more partnerships (lower-tier partnership), and the same persons own, directly or indirectly (through one or more entities), more than 50 percent of the capital and profits interests in both the upper-tier partnership and the lower-tier partnership, the lower-tier partnership must also revalue its assets immediately prior to the distribution in accordance with § 1.704–1(b)(2)(iv)(*f*) if the lower-tier partnership owns section 751 property. If the same persons do not own, directly or indirectly, more than 50 percent of the capital and profits interests in both the upper-tier partnership and the lower-tier partnership, the upper-tier partnership must allocate its distributive share of the lower-tier partnership's items among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its property.

(3) *Tax consequences of a section 751(b) distribution*—(i) *Reasonable approach.* In the case of a section 751(b) distribution described in paragraph (b)(2) of this section, the partnership must choose a reasonable approach that is consistent with the purpose of section 751(b) under which each partner with a section 751(b) amount recognizes ordinary income (or takes it into account by eliminating a basis adjustment) equal to that section 751(b) amount immediately prior to the section 751(b) distribution. In certain circumstances described in paragraph (b)(3)(ii) of this section, a distributee partner may also be permitted or required to recognize capital gain. To be reasonable, an approach must conform to the general principles and anti-abuse rules described in paragraph (b)(4) of this section. An approach is not necessarily unreasonable merely because another approach would result in a higher aggregate tax liability. Once the partnership has adopted a reasonable approach, it must apply that approach consistently for all section 751(b) distributions, including for any distributions the partnership makes after a termination of the partnership under section 708(b)(1)(B). If the application of the adopted approach to a later section 751(b) distribution produces results inconsistent with the purpose of section 751, the partnership must adopt another reasonable approach that achieves the purposes of section 751 for that distribution only. *See Example 3* through *Example 8* in paragraph (g) of this section.

(ii) *Gain Recognition*—(A) *Mandatory recognition.* A partner's net section 751 unrealized gain or net section 751 unrealized loss for purposes of paragraph (b)(3)(i) of this section is determined before taking into account any basis adjustments required by paragraph (b)(3)(iii) of this section. In certain instances, the application of paragraph (b)(3)(iii) of this section may cause a partner to receive distributed property with a basis that differs from the basis of the property in the hands of the distributing partnership. If an adjustment to the basis of the distributed section 751 property results in a section 734(b) basis adjustment, and that basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section if the section 734(b) adjustment had been included immediately prior to the distribution, then the distributee partner must recognize capital gain immediately prior to the distribution in an amount sufficient to eliminate that section 734(b) basis adjustment. *See Examples 5* and *6* in paragraph (g) of this section. If, however, the partnership makes an election under § 1.755–1(c)(2)(vi), then the partner must characterize all or a portion of the gain recognized under this paragraph as ordinary income or a dividend, as appropriate, to preserve the character of the gain in the adjusted asset. *See Example 9* in paragraph (g) of this section.

(B) *Elective recognition.* A distributee partner may elect to recognize capital gain (in addition to amounts required to be recognized under this section) to eliminate section 732(a)(2) or (b) basis adjustments to the asset or assets received in distribution if, and to the extent that, the basis adjustments required by paragraph (b)(3)(iii) of this section would otherwise cause the distributee partner's net section 751 unrealized gain to be greater immediately after the distribution than it was immediately before the distribution or would cause the distributee partner's net section 751 unrealized loss to be less immediately after the distribution than it was immediately before the distribution. A distributee partner elects under this paragraph (b)(3)(ii)(B) by providing the partnership with written notification of its intent to make the election and reporting the capital gain on its return. An extension of time to make an election under this paragraph (b)(3)(ii)(B) will not be granted under § 301.9100–3 of this chapter. The requirement in paragraph (b)(1)(i) of this section that a partnership apply a chosen reasonable method consistently across all partnership distributions does not apply for purposes of this paragraph. *See Example 7* in paragraph (g) of this section.

(iii) *Adjustments to Basis.* The partnership and its partners must make appropriate adjustments to the adjusted basis of the partners' interests in the partnership, and of section 751 property and other property held by the partnership or partners, in a manner consistent with the adopted approach to reflect any ordinary income or capital gain recognized upon application of paragraph (b)(3) of this section, and section 704(c) amounts must be adjusted accordingly.

(4) *General principles and anti-abuse rules.* (i) The purpose of section 751 is to prevent a partner from converting its rights to ordinary income into capital gain, including by relying on the rules of section 704(c) to defer ordinary income while monetizing most of the value of the partnership interest. The partnership and all partners of the partnership must apply the rules of section 751 and § 1.751–1 in a manner consistent with the purpose of section 751. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 751, the Commissioner may recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 751. The Commissioner will determine whether a tax result is inconsistent with the purpose of section 751 based on all the facts and circumstances. The existence of one or more of the situations set forth below is presumed to establish that a transaction is inconsistent with the purpose of section 751 and disclosure to the Internal Revenue Service in accordance with § 1.751–1(b)(4)(ii) is required.

(A) Circumstances in which a partner received a distribution that would otherwise be subject to section 751(b), but for the application of the principles of section 704(c), and one or more of the following conditions exist (whether at the time of the distribution or, in the case of paragraph (b)(4)(i)(A)(*2*), (*3*), (*4*), or (*5*) of this section, a later date):

(*1*) The partner's interest in net section 751 unrealized gain is at least four times greater than the partner's capital account immediately after the distribution, pursuant to § 1.704–1(b)(2)(iv) (or comparable amount for partnerships not maintaining capital accounts under § 1.704–1(b)(2)(iv));

(*2*) The partner is substantially protected from losses from the partnership's activities and has little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(*3*) The partner engages in a transaction that, at the time of the transaction, causes the net value of the partner (or its successor) to be less than the tax liability that the partner (or its successor) would incur with respect to its interest in the partnership's section 751 property upon a sale of its partnership interest for its fair market value at the time of the transaction. For this purpose, the net value of the partner (or its successor) equals—

(*i*) The fair market value of all assets owned by the partner (or its successor) that may be subject to creditor's claims under local law (including the partner's enforceable right to contributions from its owner or owners), less

(*ii*) All obligations of the partner (or its successor) other than the partner's obligation with respect to the tax liability for which the net value is being determined;

(*4*) The partner transfers a portion of its partnership interest within five years after the distribution in a manner that does not trigger ordinary income recognition, and ordinary income or gain with respect to the partnership interest is subject to Federal income tax in the hands of the transferor partner immediately before the transfer, but any ordinary income or gain with respect to the partnership interest is exempt from, or otherwise not subject to, Federal income tax in the hands of the transferee partner immediately after the transfer;

(*5*) The partnership transfers to a corporation in a nonrecognition transaction section 751 property other than pursuant to a transfer of all property used in a trade or business (excluding assets that are not material to a continuation of the trade or business); or

(B) The partners agree to change (other than a de minimis change) the manner in which the partners share any item or class of items of income, gain, loss, deduction or credit of the partnership under the partnership agreement and that change reduces the partner's net section 751 unrealized gain.

(ii) If a partner participates in a transaction described in paragraph (b)(4)(i)(A) or (B) of this section and does not recognize and report its share of ordinary income from section 751 property on its tax return for the taxable year of the transaction, the partner must file Form 8275–R, Regulation Disclosure Statement, or any appropriate successor form, disclosing its participation in the transaction for the taxable year in which the transaction occurred.

(5) *Special rules.* * * *

* * * * *

(ii) The transferee in a nonrecognition transaction of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 751(b)(2) in an amount attributable to the interest transferred.

(iii) For purposes of section 751(b)(2), if a partnership disposes of contributed section 751 property in a nonrecognition transaction, the substituted basis property (within the meaning of section 7701(a)(42)) received in exchange for such substituted basis property is treated as the contributed section 751 property with regard to the contributing partner. If a partnership transfers contributed section 751 property together with other property in a nonrecognition transaction, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as the contributed section 751 property with regard to the contributing partner in the same proportion as the fair market value of the contributed section 751 property, at the time of the transfer, bears to the fair market value of the other property transferred at the time of the transfer. If a transfer described in this paragraph (b)(5)(iii) was in exchange for an interest in an entity, the interest in the entity will not be treated as the contributed section 751 property with regard to the contributing partner to the extent the value of the interest is attributable to other property the partnership contributed to the entity.

(iv) For purposes of section 751(b)(2), an interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent the value of the interest is attributable to property the partnership contributed to the entity after the interest was contributed to the partnership. The preceding sentence does not apply to the extent that the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership.

(v) For purposes of section 751(b)(2), the distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property.

* * * * *

(6) *Statements required*—(i) *Partnership.* A partnership that makes a section 751(b) distribution must submit with its return for the year of the distribution a statement for each section 751(b) distribution made during the year that includes the following:

(A) A caption identifying the statement as the disclosure of a section 751(b) distribution and the date of the distribution; and

(B) A brief description of the reasonable approach adopted by the partnership pursuant to paragraph (b)(3)(i) of this section for recognizing the ordinary income; if applicable, the capital gain required to be recognized; and if relevant, whether the approach varies from an approach previously adopted within any of the three tax years preceding the current tax year.

(ii) *Partner.* A partnership that makes a section 751(b) distribution during the partnership's tax year must submit with its return for the year of the distribution a statement for each partner that has a section 751(b) amount greater than $0 in connection with that distribution. The statement must be attached to the statement for that partner required by section 6031(b) and § 1.6031(b)–1T(a), and must include the following:

(A) The date of the section 751(b) distribution;

(B) The amount of ordinary income the partner recognized pursuant to paragraph (b)(3)(i) of this section; and

(C) The amount of capital gain the partner recognized, if any, pursuant to paragraph (b)(3)(ii)(A) or (B) of this section.

(c) * * *

(4) * * *

(vi) With respect to any taxable year of a partnership beginning after July 18, 1984, amounts treated as ordinary income under section 467 are treated as ordinary income under this section in the same manner as amounts treated as ordinary income under section 1245 (*see* paragraph (c)(4)(iii) of this section) or section 1250 (*see* paragraph (c)(4)(v) of this section).

* * * * *

(x) With respect to any taxable year of a partnership beginning after July 18, 1984, the term *unrealized receivables,* for purposes of this section and sections 731, 732, and 741 (but not for purposes of section 736), includes any market discount bond (as defined in section 1278) and any short-term obligation (as defined in section 1283) but only to the extent of the amount that would be treated as ordinary income if (at the time of the transaction described in this section or section 731, 732, or 741, as the case may be) such property had been sold by the partnership.

* * * * *

(d) *Inventory items which have substantially appreciated in value*— (1) *Substantial appreciation.* Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment to the partner). The terms ''inventory items which have appreciated substantially in value'' or ''substantially appreciated inventory items'' refer to the aggregate of all partnership inventory items but do not include any unrealized receivables. * * *

* * * * *

(e) *Section 751 property and other property.* For purposes of paragraph (a) of this section, *section 751 property* means unrealized receivables or inventory items. For purposes of paragraph (b) of this section, *section 751 property* means unrealized receivables or substantially appreciated inventory items. For purposes of all paragraphs of this section, *other property* means all property (including money) that is not section 751 property.

(f) *Applicability date.* The rules contained in paragraph (a)(2) of this section apply to transfers of partnership interests that occur on or after November 3, 2014. The rules contained in paragraph (a)(3) of this section apply to transfers of partnership interests that occur on or after December 15, 1999. The rules contained in paragraphs (b)(2) and (3) of this section apply to distributions of partnership property that occur on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. However, a partnership and its partners may apply the rules contained in paragraph (b)(2) of this section for purposes of determining a partner's interest in the partnership's section 751 property on or after November 3, 2014, provided the partnership and its partners apply paragraphs (a)(2), (b)(2), and (b)(4) of this section consistently for all partnership sales, exchanges, and distributions, including for any distributions the partnership makes after a termination of the partnership under section 708(b)(1)(B).

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples. In each of *Examples 2* through *9* of this paragraph (g), none of the section 751 property qualifies as property that the distributee previously contributed as described in section 751(b)(2)(A), and no distribution to a retiring partner is a payment described in section 736(a):

Example 1. (i)(A) A and B are equal partners in personal service partnership PRS. A contributed nondepreciable capital assets (the ''Capital Assets'') to PRS with a basis and fair market value of $14,000. B contributed unrealized receivables described in paragraph (c) of this section (the ''Unrealized Receivables'') to PRS with a basis of zero and fair market value of $14,000. Later, when the fair market value of the Capital Assets had declined to $2,000, B transferred its interest in PRS to T for $9,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) was as follows:

	Adjusted basis	Fair market value
Assets		
Cash	$ 4,000	$ 4,000
Capital Assets	14,000	2,000
Unrealized Receivables	0	14,000
Total	18,000	20,000
Liabilities and Capital		
Liabilities	$2,000	$2,000
Capital:		
A	15,000	9,000
B	1,000	9,000
Total	18,000	20,000

(B) The total amount realized by B is $10,000, consisting of the cash received, $9,000, plus $1,000, B's share of the partnership liabilities assumed by T. *See* section 752. B's interest in the partnership property includes an interest in the partnership's Unrealized Receivables. B's basis in its partnership interest is $2,000 ($1,000, plus $1,000, B's share of partnership liabilities). If section 751(a) did not apply to the sale, B would recognize $8,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(ii) For purposes of section 751(a), the amount of money or the fair market value of property received by the partner in exchange for all or part of his partnership interest must take into account the partner's share of income or gain from section 751 property. If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $14,000 of ordinary income from the sale of PRS's Unrealized Receivables under section 704(c). Therefore, B will recognize $14,000 of ordinary income with respect to the Unrealized Receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($8,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($14,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $6,000 capital loss.

Example 2. (i) A, B, and C each contribute $120 to partnership ABC in exchange for a 1/3 interest. A, B, and C each share in the profits and losses of ABC in accordance with their 1/3 interest. ABC purchases land for $100 in Year 1. At the end of Year 3, when ABC holds $260 in cash and land with a value of $100 and has generated $90 in zero-basis unrealized receivables, ABC distributes $50 cash to C in a current distribution, reducing C's interest in ABC from 1/3 to 1/4. ABC has a section 754 election in effect. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under § 1.704–1(b)(2)(iv)(*f*) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	120	150
Totals	360	450		360	450

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $30 of net income from ABC's section 751 property. Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $30 each under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Cash	$210	$210	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	70	100
Totals	310	400		310	400

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, A, B, and C would each still be allocated $30 of net income from ABC's section 751 property pursuant to § 1.704–3(a)(6). C did not receive any section 751 property in the distribution. Accordingly, A, B, and C's net section 751 unrealized gain immediately after the distribution is $30 each under paragraph (b)(2)(iii) of this section.

(iv) Because no partner's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, and because no partner's net section 751 unrealized loss is greater immediately after the distribution than immediately before the distribution, the distribution is not a section 751(b) distribution under paragraph (b)(2)(i) of this section. Accordingly, section 751(b) does not apply to the distribution.

Example 3. (i) Assume the same facts as in *Example 2* of this paragraph (g), but assume ABC distributes $150 cash to C in complete liquidation of C's interest. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under § 1.704–1(b)(2)(iv)(*f*) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	120	150
Totals	360	450		360	450

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of these assets immediately before the distribution, A, B, and C would each be allocated $30 of net income from ABC's section 751 property. Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $30 each under paragraph (b)(2)(ii) of this section.

(iii)(A) Because ABC has elected under section 754, and because A recognizes $30 gain on the distribution of cash, the basis of the real property is increased to $130 under section 734(b). After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	130	100	C	0	0
Totals	240	300		240	300

(B) Because C is no longer a partner in ABC, C would not be allocated any net income from ABC's section 751 property immediately after the distribution. Also, C did not receive any section 751 property in the distribution. Accordingly, C's net section 751 unrealized gain immediately after the distribution is $0 under paragraph (b)(2)(iii) of this section.

(iv) Because C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, section 751(b) applies to the distribution. Under paragraph (b)(2)(i) of this section, C has a section 751(b) amount equal to $30, the amount by which C's share of pre-distribution net section 751 unrealized gain ($30) exceeds C's share of post-distribution net section 751 unrealized gain ($0). Accordingly, paragraph (b)(3)(i) of this section requires C to recognize $30 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (v) and (vi) of this example, and the second of which is described in paragraphs (vii) and (viii) of this example.

(v) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, C is deemed to recognize $30 of ordinary income. To reflect C's recognition of $30 of ordinary income, C increases its basis in its ABC partnership interest by $30, and the partnership increases its basis in the unrealized receivable by the $30 of income recognized by C, immediately before the distribution. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution immediately prior to the cash distribution, ABC's modified balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	30	90	B	120	150
Real Property	100	100	C	150	150
Totals	390	450		390	450

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, C recognizes no gain or loss under section 731(a) upon the distribution. Because C recognizes no gain on the distribution, the basis of the partnership real property is not adjusted. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized Receivable	30	90	B	120	150
Real Property	100	100	C	0	0
Totals	240	300		240	300

(vii) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, C is deemed to—

(A) Receive a distribution of ABC's unrealized receivables with a fair market value of $30 and a tax basis of $0;

(B) Sell the unrealized receivable to ABC in exchange for $30, recognizing $30 of ordinary income; and

(C) Contribute the $30 to ABC. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution immediately prior to the cash distribution, ABC's modified balance sheet is the same as the balance sheet shown in paragraph (v) of this example.

(viii) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. The tax consequences under the rules of sections 731 through 736 are the same tax consequences described in paragraph (vi) of this example.

Example 4. (i) A and B are equal partners in a partnership, AB, that owns Unrealized Receivable with a fair market value of $50 and nondepreciable real property with a basis of $50 and a fair market value of $100. A has an adjusted basis in its partnership interest of $25, and B has an adjusted basis in its partnership interest of $50. The partnership has a section 754 election in effect, and B has a basis adjustment under section 743(b) of $25 that is allocated to Unrealized Receivable. AB distributes Unrealized Receivable to A in a current distribution. To determine if the distribution is a distribution to which section 751(b) applies, AB must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) AB makes a non-mandatory revaluation of its assets and its partners' capital accounts are increased under § 1.704–1(b)(2)(iv)(*f*) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, AB's balance sheet is as follows:

	Tax	Basis adj.	Book	Capital	Tax	Special basis	Book
Unrealized Receivable	0	25	50	A	25	....	75
Real Property	50	....	100	B	25	25	75
Totals	50	25	150		50	25	150

(B) If AB disposed of all of its assets in exchange for cash in amounts equal to the fair market values of these assets immediately before the distribution, A and B would each be allocated $25 of net income from AB's section 751 property. However, B's net income from Unrealized Receivable would be offset by its $25 section 743 adjustment. § 1.743–1(j)(3). Accordingly, A and B's net section 751 unrealized gain immediately before the distribution are $25 and $0, respectively, under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), AB's balance sheet would be as follows:

	Tax	Basis adj.	Book	Capital	Tax	Carryover adjustment	Book
Carryover Adjustment	....	25	0	A	25	....	25
Real Property	50	....	100	B	25	25	75
Totals	50	25	100		50	25	100

(B) If AB disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, no partner would be allocated net income or loss from section 751 property. However, B has a carryover basis adjustment to ordinary income property of $25 under §§ 1.743–1(g)(2)(ii) and 1.755–1(c)(4), which B must treat as applied to section 751 property with fair market value of $0 pursuant to paragraph (b)(2)(ii) of this section. Accordingly, B's net section 751 unrealized loss immediately after the distribution is $25 under paragraph (b)(2)(iii)(A) of this section. If, immediately after the distribution, A disposed of Unrealized Receivable in exchange for $50 cash, A would recognize $50 of net income from section 751 property. Accordingly, A's net section 751 unrealized gain immediately after the distribution is $50 under paragraph (b)(2)(iii)(B) of this section.

(iv) Because B's net section 751 unrealized loss immediately after the distribution ($25) exceeds B's net section 751 unrealized loss immediately before the distribution ($0), the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, B has a section 751(b) amount equal to $25, the difference of B's share of pre-distribution net section 751 unrealized gain ($0) and B's share of post-distribution net section 751 unrealized loss ($25). Accordingly, paragraph (b)(3)(i) of this section requires B to account for $25 of ordinary income using a reasonable approach consistent with the purpose of this section.

(v) Assume AB adopts an approach under which, immediately before the section 751(b) distribution, B is deemed to—

(A) Receive a distribution of Unrealized Receivable with a fair market value of $25 and a tax basis of $25 (which consists of B's section 743(b) basis adjustment and is determined solely for purposes of applying a reasonable method consistent with the purposes of section 751(b));

(B) Sell Unrealized Receivable to AB in exchange for $25, so that B recognizes $0 of ordinary income, and AB receives Unrealized Receivable with a basis of $25; and

(C) Contribute the $25 to AB. Provided the partnership applies the approach consistently for all section 751(b) distributions, AB's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution, AB's modified balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
			A	0	25
Real Property	50	100	B	50	75
Totals	50	100		50	100

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, A recognizes no gain on the distribution of Unrealized Receivable, which A takes with a basis of $25.

Example 5. Capital Gain Recognition Required. (i) A, B, and C are each 1/3 partners in a partnership, ABC, that holds Unrealized Receivable 1 with a fair market value of $90, Unrealized Receivable 2 with a fair market value of $30, and nondepreciable real property with a fair market value of $180. The partnership has a section 754 election in effect. Each of the partners has an adjusted basis in its partnership interest of $0 with a fair market value of $100. None of the partners has a capital loss carryforward. ABC distributes to A Unrealized Receivable 1 in a current distribution. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under § 1.704–1(b)(2)(iv)(*f*) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$0	$90	A	$0	$100
Unrealized Receivable 2	0	30	B	0	100
Real Property	0	180	C	0	100
Totals	0	300		0	300

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $40 of net income from ABC's section 751 property ($30 each from Unrealized Receivable 1 and $10 each from Unrealized Receivable 2). Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $40 each under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	$0	$10
			B	0	100
Real Property	0	180	C	0	100
Totals	0	210		0	210

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, A, B, and C would each be allocated $10 of net income from ABC's section 751 property ($10 each from Unrealized Receivable 2). If immediately after the distribution, A disposed of Unrealized Receivable 1 in exchange for $90 cash, A would recognize $90 of net income from section 751 property. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $10 each under paragraph (b)(2)(iii)(A) of this section, and A's is $100 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iv) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, each of B and C has a section 751(b) amount equal to $30, the amount by which each partner's share of pre-distribution net section 751 unrealized gain ($40) exceeds its share of post-distribution net section 751 unrealized gain ($10). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize

$30 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers three approaches, the first of which is described in paragraphs (v) and (vi) of this example, the second of which is described in paragraphs (vii) and (viii) of this example, and the third of which is described in paragraph (ix) of this example.

(v) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $30 of ordinary income. To reflect B and C's recognition of $30 of ordinary income, B and C increase their bases in their ABC partnership interests by $30 each, and the partnership increases its basis in Unrealized Receivable 1 by $60 immediately before the distribution to A. Following the distribution to A, A's basis in Unrealized Receivable 1 is $0 under section 732(a)(2). Because ABC has elected under section 754, the distribution of Unrealized Receivable 1 to A would result in a $60 section 734(b) adjustment to Unrealized Receivable 2. *See* § 1.755–1(c)(1). Because that basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $60 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to paragraph (b)(3)(ii)(A) of this section. This gain recognition increases A's basis in its ABC partnership interest by $60 immediately before the distribution to A, eliminating the section 734(b) adjustment. *See* section 732(a)(2). In addition, the partnership increases its basis in Real Property by $60 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately prior to the distribution is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$60	$90	A	$60	$100
Unrealized Receivable 2	0	30	B	30	100
Real Property	60	180	C	30	100
Totals	120	300		120	300

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Thus, Unrealized Receivable 1 would take a $60 basis in A's hands under section 732(a), and no section 734(b) adjustment would be made to Unrealized Receivable 2. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	$0	$10
			B	30	100
Real Property	60	180	C	30	100
Totals	60	210		60	210

(vii) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of Unrealized Receivable 1 with a fair market value of $30 and tax basis of $0;

(B) Sell the unrealized receivable to ABC for $30, recognizing $30 of ordinary income; and

(C) Contribute the $30 to ABC. For the same reasons stated in paragraph (v) of this example, A recognizes capital gain of $60. To accomplish this, A, immediately before the section 751(b) distribution, is deemed to:

(*1*) Receive a distribution of Real Property with a fair market value of $60 and tax basis of $0;

(*2*) Sell the Real Property to ABC for $60, recognizing $60 of capital gain; and

(*3*) Contribute the $60 to ABC.

(viii) The partnership treats the $60 of gain recognized by A as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. Before taking into account the tax consequences of the section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (v) of this example. After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. The tax consequences under the rules of sections 731 through 736 are the same tax consequences described in paragraph (vi) of this example.

(ix) Assume alternatively that A does not recognize capital gain of $60. As a result, upon the distribution of Unrealized Receivable 1 to A, ABC makes a $60 section 734(b) adjustment to Unrealized Receivable 2. The adopted approach is not reasonable because it is contrary to paragraph (b)(3)(ii)(A) of this section.

Example 6. Capital Gain Recognition Required. (i)(A) Assume the same facts as *Example 5* of this paragraph (g), except that Unrealized Receivable 1 has a $9 tax basis, and each of the partners has an adjusted basis in its partnership interest of $3. Before the distribution, ABC's balance sheet is as follows:

%	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$9	$90	A	$3	$100
Unrealized Receivable 2	0	30	B	3	100
Real Property	0	180	C	3	100
Totals	9	300		9	300

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $37 of net income from ABC's section 751 property ($27 each from Unrealized Receivable 1 and $10 each from Unrealized Receivable 2). Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $37 each under paragraph (b)(2)(ii) of this section.

(ii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$6	$30	A	$0	$10
			B	3	100
Real Property	0	180	C	3	100
Totals	6	210		6	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately after the distribution, taking into account the $6 section 734(b) adjustment allocated to Unrealized Receivable 2, A, B, and C would each be allocated $8 of net income from ABC's section 751 property ($8 each from Unrealized Receivable 2). If, immediately after the distribution, A disposed of Unrealized Receivable 1 for cash in an amount equal to its fair market value, A would recognize $87 of net income from section 751 property. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $8 each under paragraph (b)(2)(iii)(A) of this section, and A's is $95 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iii) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, each of B and C has a section 751(b) amount equal to $29, the amount by which each partner's share of pre-distribution net section 751 unrealized gain ($37) exceeds its share of post-distribution net section 751 unrealized gain ($8). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $29 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (iv) and (v) of this example, and the second of which is described in paragraphs (vi) and (vii) of this example.

(iv) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $29 of ordinary income. To reflect B and C's recognition of $29 of ordinary income, B and C increase their bases in their ABC partnership interests by $29 each, and the partnership increases its basis in Unrealized Receivable 1 by $58 to $67 immediately before the distribution to A. Following the distribution to A, A's basis in Unrealized Receivable 1 is $3 under section 732(a)(2). Because ABC has elected under section 754, the distribution of Unrealized Receivable 1 to A would result in a $64 section 734(b) adjustment to Unrealized Receivable 2 (rather than the $6 section 734(b) adjustment computed prior to the application of this section). *See* § 1.755–1(c)(1). Because that additional basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $58 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to paragraph (b)(3)(ii)(A) of this section. This gain recognition increases A's basis in its ABC partnership interest by $58 to $61 immediately before the distribution to A. In addition, the partnership increases its basis in Real Property by $58 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately prior to the distribution is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$67	$90	A	$61	$100
Unrealized Receivable 2	0	30	B	32	100
Real Property	58	180	C	32	100
Totals	125	300		125	300

(v) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Thus, A would take a $61 tax basis in Unrealized Receivable 1 under section 732(a), and a $6 section 734(b) adjustment would be made to Unrealized Receivable 2. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$6	$30	A	$0	$10
			B	32	100
Real Property	58	180	C	32	100
Totals	64	210		64	210

(vi) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of Unrealized Receivable 1 with a fair market value of $29 and tax basis of $0;

(B) Sell the unrealized receivable to ABC for $29, recognizing $29 of ordinary income; and

(C) Contribute the $29 to ABC. For the same reasons stated in paragraph (iv) of this example, A recognizes capital gain of $58. To accomplish this, A, immediately before the section 751(b) distribution, is deemed to:

(*1*) Receive a distribution of Real Property with a fair market value of $58 and tax basis of $0;

(*2*) Sell the Real Property to ABC for $58, recognizing $58 of capital gain; and

(*3*) Contribute the $58 to ABC.

(vii) The partnership treats the $58 of gain recognized by A as reducing A's $60 reverse section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (iv) of this example. After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. The tax consequences under the rules of sections 731 through 736 are the same tax consequences described in paragraph (v) of this example.

Example 7. Capital Gain Recognition Elective. (i)(A) Assume the same facts as described in *Example 6* of this paragraph (g), including that ABC adopts the deemed gain approach described in paragraph (iv), except that ABC does not have a section 754 election in effect. As in *Example 6,* each of A, B, and C has net section 751 unrealized gain of $37 immediately before the distribution. After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	0	10
			B	3	100
Real Property	0	180	C	3	100
Totals	0	210		6	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately after the distribution, because there is no section 734(b) adjustment allocated to Unrealized Receivable 2, A, B, and C would each be allocated $10 of net income from ABC's section 751 property ($10 each from Unrealized Receivable 2). If, immediately after the distribution, A disposed of Unrealized Receivable 1 for cash in an amount equal to its fair market value, A would recognize $87 of net income from section 751 property. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $10 each under paragraph (b)(2)(iii)(A) of this section, and A's is $97 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(ii) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section B and C each have a section 751(b) amount equal to $27, the amount by which those partners' shares of pre-distribution net section 751 unrealized gain ($37), exceeds their shares of post-distribution net section 751 unrealized gain ($10). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $27 of ordinary income using a reasonable approach consistent with the purpose of this section.

(iii) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $27 of ordinary income. To reflect B and C's recognition of $27 of ordinary income, B and C increase their bases in their ABC partnership interests by $27, and the partnership increases its basis in Unrealized Receivable 1 by $54 to $63 immediately before the distribution to A. The distribution to A results in an adjustment to the basis of the distributed Unrealized Receivable 1 under section 732(a)(2), reducing the basis of Unrealized Receivable 1 in the hands of A to $3. Because ABC has not elected under section 754 and does not have a substantial basis reduction under section 734(d), this $60 decrease to the basis of Unrealized Receivable 1 will not affect the basis of other assets held by ABC. Thus, the distribution does not alter the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section. Accordingly, A is not obligated under paragraph (b)(3)(ii)(A) of this section to recognize gain or income upon the distribution of Unrealized Receivable 1. However, A may elect to recognize $60 of capital gain under paragraph (b)(3)(ii)(B) of this section to eliminate the section 732 basis adjustment to the distributed Unrealized Receivable 1 which would otherwise cause A's net section 751 unrealized gain to be greater immediately after the distribution than it was immediately before the distribution. This gain recognition increases A's basis in its ABC partnership interest by $60 immediately before the distribution to A. In addition, the partnership increases its basis in Real Property by $60 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse section 704(c) amount in the Real Property. A receives the distributed Unrealized Receivable 1 with a basis of $63, so that the distribution does not increase A's net section 751 unrealized gain. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	0	10
			B	30	100
Real Property	60	180	C	30	100
Totals	60	210		60	210

Example 8. (i) A, B, and C, each domestic corporations, are 1/3 partners in a domestic partnership ABC. ABC purchased 100% of the stock in two foreign corporations, X and Y. X and Y each have one share of stock outstanding. ABC has a basis of $15 in its X share with a fair market value of $150, and a basis of $3 in its Y share with a fair market value of $30. The earnings and profits of X that are attributable to ABC's X stock under section 1248 are $135; the earnings and profits of Y that are attributable to ABC's Y stock are $27. ABC has a section 754 election in effect. Each of A, B, and C has a partnership interest with an adjusted basis of $6 and a fair market value of $60. On January 1, 2013, ABC distributes the Y share to A in a current distribution. To determine if the distribution is a distribution to which section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets. Its partners' capital accounts are increased under § 1.704–1(b)(2)(iv)(*f*) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows (with the shares of X and Y each reflected as having both an unrealized receivable component and a capital gain component):

	Tax	Book	Capital	Tax	Book
X stock (total)	$15	$150	A	$6	$60
Unrealized receivable	0	135	B	6	60
Capital gain asset	15	15	C	6	60
Y stock (total)	3	30		....	....
Unrealized receivable	0	27		....	....
Capital gain asset	3	3		....	....
Totals	18	180		18	180

(B) If ABC disposed of all of its assets for cash in an amount equal to the assets' fair market value immediately before the distribution, A, B, and C would each be allocated $54 of net income from ABC's section 751 property ($45 each from X stock and $9 each from Y stock). Accordingly, A, B, and C's net section 751 unrealized gain immediately before the distribution is $54 each under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock (total)	$15	$150	A	$3	$30
Unrealized receivable	0	135	B	6	60
Capital gain asset	15	15	C	6	60
Totals	15	150		15	150

(B) If ABC disposed of its asset for cash in an amount equal to the fair market value of that asset immediately after the distribution, A, B, and C would each be allocated $45 of net income from ABC's section 751 property pursuant to § 1.704–3(a)(6). A, however, received Y stock, which continues to be section 751 property in A's hands under section 735(a), with a holding period that includes the partnership's holding period under section 735(b). If A disposed of its Y stock for cash in an amount equal to its fair market value, A would recognize $27 of gain under section 751(b) on the Y stock (a foreign corporation described in section 1248) that is included in A's income under section 1248 as a dividend to the extent of the attributable earnings. Accordingly, B and C's net section 751 unrealized gain immediately after the distribution is $45 each under paragraph (b)(2)(iii)(A) of this section, and A's is $72 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iv) Because B and C's net section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a section 751(b) distribution. Under paragraph (b)(2)(i) of this section, B and C each have a section 751(b) amount equal to $9, the amount by which those partners shares of pre-distribution net section 751 unrealized gain ($54) exceeds their shares of post-distribution net section 751 unrealized gain ($45). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $9 as a dividend under section 1248 using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (v) and (vi) of this example, and the second of which is described in paragraph (vii) of this example.

(v) Assume ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to recognize $9 of gain includible as a dividend with respect to the distribution of the Y stock, which is treated as a sale or exchange for purposes of section 1248. To reflect B and C's recognition of $9 of dividend income, B and C increase the bases in their ABC partnership interests by $9 each, and the partnership increases its basis in the Y share unrealized receivable component by $18 immediately before the distribution. The portion of the unrealized receivable component of the Y share that is deemed to be sold or exchanged under section 1248 has a new holding period beginning on the day after the section 751(b) distribution (''the new holding period portion''). The earnings and profits of $18 attributable to the new holding period portion of the Y share are 2/3 of the total earnings and profits attributable to the Y share immediately before the distribution (B and C's $18 aggregate gain recognized under section 751(b) divided by $27, the aggregate of all the partners' net section 751 unrealized gain immediately before the distribution). The remaining earnings and profits are allocated to the remainder of the Y share. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately before the distribution is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$15	$150	A	$6	$60
Unrealized receivable	0	135	B	15	60
Capital gain asset	15	15	C	15	60
Y stock	21	30		....	....
New holding period portion	18	18		....	....
Unrealized receivable	0	9		....	....
Capital gain asset	3	3		....	....
Totals	36	180		36	180

(vi) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, the basis of the distributed Y stock in A's hands is limited under section 732(a)(2) to A's $6 basis in its partnership interest. Pursuant to section 732(c)(3)(B), the $15 decrease in basis from $21 to $6 must be allocated to the distributed components of the Y stock in proportion to their respective adjusted bases. A must allocate the $15 decrease in basis in the Y stock between the new holding period portion (which has a basis of $18) and the remainder of the Y share (which has a basis of $3). Accordingly, A receives the new holding period portion of the Y share with an adjusted basis of $5.14 ($6 multiplied by ($18 divided by $21)), and the remainder of the Y share with an adjusted basis of $0.86 ($6 multiplied by ($3 divided by $21)). Because the basis of the distributed Y stock in A's hands was reduced from $21 (the basis of the Y stock in the hands of ABC) to $6 (the basis in A's hands), ABC must increase the basis of its remaining asset under section 734(b)(1)(B) by $15. ABC must allocate the $15 under § 1.755–1(c)(1)(i) to the capital gain portion of the X stock. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$0	$30
Unrealized receivable	0	135	B	15	60
Capital gain asset	30	15	C	15	60

	Tax	Book	Capital	Tax	Book
Totals	30	150		30	150

(vii) Assume alternatively that ABC adopts an approach under which, immediately before the section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of the portion of the partnership's Y stock with a fair market value of $9 and a tax basis of $0;

(B) Sell the Y stock back to ABC for $9, recognizing $9 of gain includible as a dividend; and

(C) Contribute the $9 to ABC. ABC will be deemed to have purchased for $18 a portion of the Y stock unrealized receivable component, which will have a new holding period. The deemed sale of Y stock by B and C to ABC will be treated as a sale or exchange for purposes of section 1248. Provided that the partnership applies the approach consistently for all section 751(b) distributions, Partnership ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed transaction, ABC's balance sheet is the same as the balance sheet shown in paragraph (v) of this example. After taking into account the tax consequences of the section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (vi) of this example.

(viii) Assume that in a later unrelated transaction, A sells its Y stock at a time when its fair market value, earnings and profits, and adjusted basis have not changed. The sale of Y stock by A is a sale or exchange subject to section 1248. Pursuant to § 1.732–1(c)(2)(v), in determining the dividend portion of its gain on the Y stock under section 1248, A does not take into account the $15 decrease in basis under section 732. Accordingly, upon the sale of the Y stock, A recognizes $9 of gain, the lesser of $9 ($0 gain on the new holding period portion ($18 fair market value minus $18 basis) plus $9 gain on the remainder ($12 fair market value minus $3 basis)) or $9 (earnings and profits attributable to the remainder of the Y share) as dividend income under section 1248. A recognizes $15 of capital gain in addition to the $9 of dividend income ($30 amount realized minus $15 ($6 aggregate basis in Y share plus $9 section 1248 dividend income)).

(ix) Assume that ABC also sells its X stock in a later unrelated transaction at a time when its fair market value has declined to $120 but earnings and profits have remained the same. ABC has not made an election under § 1.755–1(c)(2)(vi). In determining the dividend portion of its gain on the X stock under section 1248, ABC does not take into account the $15 increase in basis under section 734(b). Upon the sale of the stock, ABC recognizes $105, the lesser of $105 ($120–$15) or $135 (earnings and profits attributable to the X stock for the partnership's holding period) as dividend income. In addition to the $105 of gain includible as a dividend, ABC recognizes $15 of capital loss ($120 amount realized minus $135 ($30 aggregate basis in X stock plus $105 section 1248 dividend income)).

Example 9. (i) Assume the same facts as in *Example 8* of this paragraph (g), except assume that Partnership ABC makes an election under § 1.755–1(c)(2)(vi). As in *Example 8,* paragraph (b)(3)(i) of this section requires each of B and C to recognize $9 as a dividend under section 1248 using a reasonable approach consistent with the purpose of this section for the reasons described in paragraphs (ii) through (iv) of *Example 8.* Further assume that ABC adopts the deemed gain approach described in paragraph (v) of *Example 8.* As in *Example 8,* B and C are each deemed to recognize $9 of dividend income with respect to the distribution of the Y stock, which is treated as a sale or exchange for purposes of section 1248. To reflect B and C's recognition of $9 of dividend income, B and C increase the bases in their ABC partnership interests by $9 each. The partnership increases its basis in the Y share unrealized receivable component by $18 immediately before the distribution. The portion of the unrealized receivable component of the Y share that is deemed to be sold or exchanged under section 1248 has a new holding period beginning on the day after the section 751(b) distribution (''the new holding period portion'').

(ii) Because ABC makes an election under § 1.755–1(c)(2)(vi), the distribution of the Y share to A results in a $15 section 734(b) adjustment to the unrealized receivable component of the X share. Because that basis adjustment would have altered the amount of net section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $15 of gain with respect to the X share pursuant to paragraph (b)(3)(ii)(A) of this section. Also pursuant to paragraph (b)(3)(ii)(A) of this section, A's recognition of income with respect to the X stock is a sale or exchange for purposes of section 1248 and begins a new holding period for this portion of ABC's X stock, including for purposes of attributing earnings and profits. This income recognition increases A's basis in its ABC partnership interest by $15 immediately before the distribution to A. In addition, the partnership increases its basis in the X share by $15, immediately before the distribution to A. The partnership treats the $15 of dividend income recognized by A as reducing A's $15 reverse section 704(c) amount in the X stock. Provided the partnership applies the approach consistently for all section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described above, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$21	$60
Unrealized receivable	0	120	B	15	60
Capital gain asset	30	30	C	15	60
Y stock	21	30		....	....
Unrealized receivable	0	9		....	....
Capital gain asset	21	21		....	....
Totals	51	180		51	180

(iii)(A) After determining the tax consequences of the section 751(b) distribution, the rules of sections 731 through 736 apply. Accordingly, the Y stock would take a $21 basis in A's hands under section 732(a), and no section 734(b) adjustment would be made to the X stock. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$0	$30
Unrealized receivable	0	120	B	15	60
Capital gain asset	30	30	C	15	60
Totals	30	150		30	150

(B) If the partnership sells the X stock, the gain recognized is $120 ($150—$30), all of which is recharacterized as a dividend under section 1248. Because A's recognition of $15 of dividend income reduced A's reverse section 704(c) amount in the X stock, this gain is allocated $45 to B, $45 to C, and $30 to A.

■ **Par. 8.** Section 1.755–1 is amended by:

■ a. Adding paragraphs (c)(2)(iii), (iv), (v), and (vi).

■ b. Revising the paragraph heading and the introductory text of paragraph (c)(6).

■ c. Removing the paragraph heading ''*Example.''* in paragraph (c)(6) and adding ''*Example 1.''* in its place.

■ d. Adding *Examples 2* and *3* to paragraph (c)(6).

■ e. Revising paragraph (e)(2).

The additions and revisions read as follows:

§ 1.755–1 Rules for allocation of basis.

* * * * *

(c) * * *

(2) * * *

(iii) *Coordination with section 1245 and similar provisions.* Any increase in basis allocated to capital gain property pursuant to the second sentence in paragraph (c)(2)(i) of this section is not taken into account in determining the recomputed or adjusted basis in the property for purposes of section 1245(a)(1). Notwithstanding the prior sentence, any depreciation or amortization of the increase in basis that is allowed or allowable is taken into account in computing the property's recomputed basis. In the case of property that is subject to section 617(d)(1), 1250(a)(1), 1252(a)(1), or 1254(a)(1), rules similar to the rule in this paragraph (c)(2)(iii) shall apply.

(iv) *Coordination with section 1231.* Any increase in basis allocated to capital gain property pursuant to the second sentence in paragraph (c)(2)(i) of this section is not taken into account in determining section 1231 gain and loss, as defined in section 1231(a)(3). Any basis adjustment to an asset not taken into account pursuant to this paragraph (c)(2)(iv) shall be treated as gain from the sale or exchange of a capital asset with the same holding period as the underlying asset.

(v) *Coordination with sections 1248 and 995.* Any increase in basis allocated to stock in a foreign corporation pursuant to the second sentence in paragraph (c)(2)(i) of this section, or any decrease in basis allocated to stock in a foreign corporation pursuant to the second sentence in paragraph (c)(2)(ii) of this section, is not taken into account in determining the amount of gain recognized on the sale or exchange of such stock for purposes of section 1248(a). In the case of property that is subject to section 995(c), rules similar to the rule set forth in this paragraph (c)(2)(v) shall apply.

(vi) *Election not to apply the provisions of paragraphs (c)(2)(iii), (iv), and (v).* A partnership may elect not to apply paragraphs (c)(2)(iii), (iv), and (v) of this section, and § 1.732–1(c)(2)(iii), (iv), and (v). An election made under this paragraph (c)(2)(vi) shall apply to all property distributions taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years (including after a termination of the partnership under section 708(b)(1)(B)). An election under this paragraph (c)(2)(vi) must be made in a written statement filed with the partnership return for the first taxable year in which any of paragraph (c)(2)(iii), (iv), or (v) of this section, or § 1.732–1(c)(2)(iii), (iv), and (v), would have applied if no election was made. An election under this paragraph (c)(2)(vi) is valid only if the required statement is included with a partnership return that is filed not later than the time prescribed by paragraph (e) of this section or § 1.6031(a)–1 (including extensions thereof) for filing the return for such taxable year. This election is a method of accounting under section 446, and once the election is made, it can be revoked only with the consent of the Commissioner. The revocation of the election, or the making of a late election, under this paragraph (c)(2)(vi) is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. *See* paragraph (c)(6), *Example 3,* of this section for the treatment of a section 734(b) adjustment if an election under this paragraph (c)(2)(vi) is made, and certain consequences of the election under section 751(b). The statement required by this paragraph (c)(2)(vi) shall—

(A) Set forth the name and address of the partnership making the election;

(B) Be signed by any officer, manager, or member of the partnership who is authorized (under local law or the partnership's organizational documents) to make the election and who represents to having such authorization under penalties of perjury; and

(C) Contain a declaration that the partnership elects not to apply paragraphs (c)(2)(iii), (iv), and (v) of this section and § 1.732–1(c)(2)(iii), (iv), and (v).

* * * * *

(6) *Examples.* The following examples illustrate this paragraph (c):

* * * * *

Example 2. (i) A, B, and C are equal partners in ABC. Each partner has an outside basis in its partnership interest of $20. ABC owns depreciable equipment X with an adjusted basis of $30 and a fair market value of $150 and depreciable equipment Y with an adjusted basis of $30 and a fair market value of $30. ABC has made an election under section 754.

(ii) The depreciable equipment X has $120 of adjustments reflected in its adjusted basis within the meaning of § 1.1245–2(a)(2). Accordingly, the entire $120 of the gain with respect to depreciable equipment X would be treated as gain to which section 1245(a)(1) would apply if the partnership sold the depreciable equipment X for its fair market value. ABC, therefore, has a $120 unrealized receivable within the meaning of § 1.751–1(c)(4)(iii). Assume ABC makes a current distribution of the depreciable equipment Y to A. Because A's basis in his partnership interest is only $20, A's basis in the depreciable equipment Y will be limited to $20 under section 732(a). Under section 734(b), ABC will increase the basis in its capital gain property by $10 and will not adjust the basis of ordinary income property. Assume ABC has not made an election under § 1.755–1(c)(2)(vi).

(iii) *Allocation between classes.* Pursuant to § 1.755–1(a)(1), ABC's $120 unrealized receivable associated with the depreciable equipment X is treated as a separate asset that is ordinary income property. Thus, ABC is treated as having two assets (each actually a component of the single asset, equipment X) after the distribution, one that is capital gain property with a basis of $30 and a fair market value of $30, and one that is ordinary income property with a basis of $0 and a fair market value of $120.

(iv) *Allocation within class.* ABC must allocate the $10 basis increase entirely to the capital gain portion of the depreciable equipment X, as it holds no other capital gain property after it distributes the depreciable equipment Y to A. Therefore, ABC increases the basis of the capital gain property to $40.

(v) *Treatment of section 734(b) adjustment.* Pursuant to paragraph (c)(2)(iii) of this section, if ABC sold its depreciable equipment X for $150 immediately after the distribution to A, ABC would not take into account the $10 section 734(b) adjustment in determining ABC's recomputed or adjusted basis in the depreciable equipment X for purposes of section 1245(a)(1) and, accordingly, would recognize $120 of ordinary income. Also pursuant to paragraph (c)(2)(iv) of this section, the $10 section 734(b) adjustment is not taken into account for purposes of determining section 1231 gain or loss. Thus, pursuant to paragraph (c)(2)(vi) of this section, ABC would recognize a $10 capital loss.

(vi) *Treatment of additional depreciation and appreciation.* (A) Assume, instead, that ABC continues to own the equipment and takes additional depreciation deductions of $16 ($15 with respect to the original remaining $30 basis and $1 with respect to the additional $10 basis resulting from the section 734(b) adjustment). At a time when the equipment has appreciated in value to $170, ABC sells the depreciable equipment X for $170 in a taxable transaction. In that same taxable year, ABC does not sell any other property used in its trade or business.

(B) Pursuant to section 1245(a)(1), ABC must recognize ordinary income in an amount by which the lesser of the following two amounts exceeds ABC's adjusted basis in the depreciable equipment X—

(*1*) ABC's recomputed basis in the depreciable equipment, or

(*2*) ABC's amount realized;

(C) Pursuant to section 1245(a)(2)(A), ABC's recomputed basis is an amount equal to the sum of—

(*1*) ABC's adjusted basis of the property, plus

(*2*) The amount of adjustments reflected in the adjusted basis on account of deductions allowed or allowable.

(D) Pursuant to (c)(2)(iii) of this section, the $9 remaining section 734(b) adjustments is not taken into account in determining ABC's recomputed or adjusted basis in the property for purposes of section 1245(a)(1). Thus, ABC's adjusted basis in the property is $15 (the remaining original basis). Also pursuant to (c)(2)(iii) of this section, however, any depreciation, or amortization of the section 734(b) adjustment that is allowed or allowable is taken into account in computing the property's recomputed basis. Thus, ABC's amount of adjustments reflected in the adjusted basis is $136 (the original $120 adjustment for depreciation deductions plus the additional $15 adjustment for depreciation deductions plus the additional $1 adjustment for depreciation deductions taken with respect to the section 734(b) adjustment). Accordingly, ABC's recomputed basis is $151 ($15 adjusted basis plus $136 of adjustments), which is lower than ABC's amount realized of $170. ABC, therefore, must recognize ordinary income in an amount by which ABC's recomputed basis of $151 exceeds ABC's adjusted basis in the depreciable equipment X. Pursuant to (c)(2)(iii) of this section, the $9 remaining section 734(b) adjustments is not taken into account in determining the adjusted basis in the property for purposes of section 1245(a)(1). Accordingly, ABC must recognize $136 of ordinary income (the excess of ABC's $151 recomputed basis in the depreciable equipment X over ABC's $15 adjusted basis in the depreciable equipment X).

(E) Pursuant to paragraph (c)(2)(iv) of this section, the section 734(b) adjustment is not taken into account in determining ABC's section 1231 gain or loss. Accordingly, pursuant to section 1231(a)(1), ABC recognizes $19 of capital gain (ABC's $170 amount realized on the disposition of the depreciable equipment X over ABC's adjusted basis of $15 in the depreciable equipment X, reduced by the $136 of ordinary income ABC recognized under section 1245(a)(1)). Pursuant to paragraph (c)(2)(vi) of this section, ABC also recognizes a capital loss equal to the remaining $9 section 734(b) adjustment.

Example 3. (i) Assume the same facts as *Example 2* of this paragraph (c), except ABC has made an election under paragraph (c)(2)(vi) of this section.

(ii) *Treatment of section 734(b) adjustment.* Because ABC has made an election under paragraph (c)(2)(vi) of this section, paragraph (c)(2)(iii) of this section does not apply. Thus, if ABC sold its depreciable equipment X immediately after the distribution to A, ABC would take into account the $10 section 734(b) adjustment in determining ABC's recomputed or adjusted basis in the depreciable equipment X for purposes of section 1245(a)(1) and, accordingly, would recognize $110 of ordinary income (including for purposes of applying section 751).

* * * * *

(e) * * *

(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, and paragraphs (c)(2)(iii), (iv), (v), (vi), and (c)(6) of this section and *Examples 2* and *3* of paragraph (c) of this section apply to distributions of property from a partnership that occur on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 9. Section 1.995–4 is amended by revising the section heading and adding a new sentence at the end of paragraph (a)(1) to read as follows:

§ 1.995–4 Gain on certain dispositions of stock in a DISC.

(a) * * * (1) * * * *But see* §§ 1.732–1(c)(2)(v) and 1.755–1(c)(2)(v) for rules governing the application of section 995(c) to partnership property in situations in which the basis of the property is increased or decreased under section 732 or 734(b).

* * * * *

Par. 10. Section 1.1231–1 is amended by adding a new sentence after the third sentence in the introductory text of paragraph (d) to read as follows:

§ 1.1231–1 Gains and losses from the sale or exchange of certain property used in the trade or business.

* * * * *

(d) * * * *See also* §§ 1.732–1(c)(2)(iv) and 1.755–1(c)(2)(iv) for rules governing the application of section 1231 to partnership property in situations in which the basis of the property is increased under section 732 or 734(b). * * *

* * * * *

§ 1.1245–2 [Amended]

Par. 11. Section 1.1245–2 is amended by removing paragraph (c)(6)(ii) and redesignating paragraph (c)(6)(iii) as paragraph (c)(6)(ii).

Par. 12. Section 1.1245–4 is amended by revising paragraphs (f)(2)(ii) and (f)(3) and *Example 2* to read as follows:

§ 1.1245–4 Exceptions and limitations.

* * * * *

(f) * * *

(2) * * *

(ii) The portion of such potential section 1245 income which is recognized as ordinary income under paragraphs (b)(3)(i) and (b)(4)(i) of § 1.751–1.

(3) * * *

Example 2. Assume the same facts as in *Example 1* of this paragraph (f) except that the machine had been purchased by the partnership. Assume further that upon the distribution, $4,000 of gain is recognized as ordinary income under section 751(b). Under section 1245(b)(3), gain to be taken into account under section 1245(a)(1) by the partnership is limited to $4,000. Immediately after the distribution, the amount of adjustments reflected in the adjusted basis of the property is $2,000 (that is, potential section 1245 income of the partnership, $6,000, minus gain recognized under section 751(b), $4,000). Thus, if the adjusted basis of the machine in the hands of C were $10,000, the recomputed basis of the machine would be $12,000 ($10,000 plus $2,000).

* * * * *

■ **Par. 13.** Section 1.1248–1 is amended by adding a new sentence at the end of paragraph (a)(1) to read as follows:

§ 1.1248–1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) * * * (1) * * * *See also* §§ 1.732–1(c)(2)(v) and 1.755–1(c)(2)(v) for rules governing the application of section 1248 to partnership property in situations in which the basis of the property is increased or decreased under section 732 or 734(b).

* * * * *

■ **Par. 14.** Section 1.1250–1 is amended by revising the section heading and adding a new sentence at the end of paragraph (f) to read as follows:

§ 1.1250–1 Gain from disposition of certain depreciable property.

(f) * * * *See also* §§ 1.732–1(c)(2)(iii) and 1.755–1(c)(2)(iii) for rules governing the application of section 1250 to partnership property in situations in which the basis of the property is increased under section 732 or 734(b).

* * * * *

■ **Par. 15.** Section 1.1252–2 is amended by adding a new sentence at the end of paragraph (c)(2)(vii) to read as follows:

§ 1.1252–2 Special rules.

* * * * *

(c) * * *

(2) * * *

(vii) * * * *See also* §§ 1.732–1(c)(2)(iii) and 1.755–1(c)(2)(iii) for rules governing the application of section 1252 to partnership property in situations in which the basis of the property is increased under section 732 or 734(b).

* * * * *

■ **Par. 16.** Section 1.1254–5 is amended by revising the introductory text of paragraph (b)(1) to read as follows:

§ 1.1254–5 Special rules for partnerships and their partners.

* * * * *

(b) *Determination of gain treated as ordinary income under section 1254 upon the disposition of natural resource recapture property by a partnership*—(*1*) *General rule.* Upon a disposition of natural resource recapture property by a partnership, the amount treated as ordinary income under section 1254 is determined at the partner level. *See also* §§ 1.732–1(c)(2)(iii) and 1.755–1(c)(2)(iii) for rules governing the application of section 1254 to partnership property in certain situations. Each partner must recognize as ordinary income under section 1254 the lesser of—

* * * * *

■ **Par. 17.** Section 1.6050K–1 is amended by revising paragraph (a)(4)(ii) and adding a new sentence after the third sentence of paragraph (c) introductory text to read as follows:

§ 1.6050K–1 Returns relating to sales or exchanges of certain partnership interests.

(a) * * *

(4) * * *

(ii) *Section 751 property.* For purposes of this section, the term ''section 751 property'' means unrealized receivables, as defined in section 751(c) and the regulations, and inventory items, as defined in section 751(d) and the regulations.

* * * * *

(c) * * * With respect to any statement required to be furnished to a transferor, the statement shall, in addition to the other information required, include the amount of any gain or loss attributable to section 751 property that is required to be recognized pursuant to paragraph (a)(2) of § 1.751–1. * * *

* * * * *

■ **Par. 18.** For each section listed in the table, remove the language in the ''Remove'' column and add in its place the language in the ''Add'' column as set forth below:

Section	Remove	Add
§ 1.704–3, paragraph (a)(6)(ii)	§ 1.743–1(b) or 1.751–1(a)(2)	§ 1.743–1(b), 1.751–1(a)(2), or 1.751–1(b).
§ 1.751–1, paragraph (c)(4)(i) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(ii), first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(iii) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(iv) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(v) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(vii) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(viii) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (c)(4)(ix) first and last sentences.	sections 731, 736, 741, and 751	sections 731, 732, and 741 (but not for purposes of section 736).
§ 1.751–1, paragraph (d)(2)(i) last sentence	section 1221(1)	section 1221(a)(1).
§ 1.751–1, paragraph (d)(2)(ii) second sentence	section 1221(4)	section 1221(a)(4).
§ 1.1245–1, paragraph (a) last sentence	see section 1245(b) and § 1.1245–4	*see* section 1245(b), and §§ 1.732–1(c)(2)(iii), 1.755–1(c)(2)(iii), and 1.1245–4.
§ 1.1245–2, paragraph (c)(6)(i)	1245(b)(6)(B)	1245(b)(5)(B).

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

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