

Internal Revenue Service, Treasury

§ 1.705-2

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

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

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

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

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

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

(a) *Purpose.* This section coordinates the application of sections 705 and 1032 and is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). However, in situations where a section 754 election was not in effect for the year in which a partner acquired its interest, the partner's inside basis and outside basis may not be equal. In these situations, gain or loss allocated to the

partner upon disposition of the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss) therefore generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allocated to the corporate partner by the partnership.

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

if, for the year in which the corporation acquired the interest, a section 754 election had been in effect.

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

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

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

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

(2) [Reserved]

(c) *Tiered partnerships and other arrangements*—(1) *Required adjustments.* The purpose of these regulations as set forth in paragraph (a) of this section cannot be avoided through the use of tiered partnerships or other arrangements. For example, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corpora-

tion acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

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

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

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

under section 705(a)(1). The basis of UTP's interest in LTP immediately after the sale of the E stock is \$1,500,000.

(iii) With respect to the basis of E's interest in UTP, if E's share of the gain allocated to UTP and then to E were to increase the basis of E's interest in UTP, E's basis in such interest would be \$725,000 (\$250,000 + \$475,000) and the fair market value of such interest would be \$500,000, so that E would recognize a loss of \$225,000 if E sold its interest in UTP immediately after LTP's disposition of the E stock. It would be inappropriate for E to recognize a taxable loss of \$225,000 upon a disposition of its interest in UTP because E would not incur an economic loss in the transaction, and E did not recognize a taxable gain upon LTP's disposition of the E stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing E's basis in its UTP interest by the entire amount of gain allocated to E from the sale of the E stock is not consistent with the purpose of this section. (Conversely, because A and B were allocated taxable gain on the disposition of the E stock, it would be appropriate to increase A's and B's bases in their respective interests in UTP by the full amount of the gain allocated to them.)

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

743(b)) would be \$1,900,000. E's share of this gain, \$475,000, would be offset in part by the \$225,000 basis adjustment under section 743(b), so that E would recognize gain equal to \$250,000 in the absence of section 1032.

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

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

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

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

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

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of \$190,000 ($\$100,000 + \$90,000$) and a value of \$100,000, so that B would recognize a loss of \$90,000 if B sold its interest in UTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B

from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective interests in UTP by the amount of gain recognized by A and C.)

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

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal \$100,000. This would conform to B's share of UTP's basis in the LTP interest ($(\$480,000 - \$180,000)$ (i.e., A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election) $\times 1/3 = \$100,000$) as well as B's indirect share of the cash held by LTP ($(1/3 \times 1/3) \times \$900,000 = \$100,000$). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the \$90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is \$100,000.

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

UTP realizes \$180,000 of loss, and A and C in turn each realize \$90,000 of loss.

(d) [Reserved]

(e) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

[T.D. 8986, 67 FR 15114, Mar. 29, 2002]

§ 1.706-1 Taxable years of partner and partner-ship.

(a) *Year in which partnership income is includible.* (1) In computing his taxable income for a taxable year, a partner is required to include his distributive share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year "guaranteed payments" under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of \$1,200 for services and for the use of capital. Of this amount, \$700 was received by A between June 1 and December 31, 1955, and the remaining \$500 was received by him between January 1 and May 31, 1956. This entire \$1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner's gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) *Adoption or change in taxable year—(1) Partnership taxable year.* (i) The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal

partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) *Partner's taxable year.* A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) *Principal partner.* For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) *Application for approval—(i) Change.* Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner of Internal Revenue, Washington, DC 20224. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period.

(ii) *Adoption.* Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.