

**Example 1. Recognition of gain.** (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. Thus, there is a built-in gain of \$6,000 on Property A at the time of contribution. B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) and § 1.704-3 on the sale of Property A at the time of the distribution (\$10,000 fair market value less \$4,000 adjusted tax basis). As a result, A must recognize \$6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and § 1.704-3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

**Example 2. Effect of post-contribution depreciation deductions.** (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. Therefore, there is a built-in gain of \$10,000 on Property A. B and C each contribute \$30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in § 1.704-3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of \$3,000 per year (10 percent of the \$30,000 book basis), and each partner is allocated \$1,000 of book depreciation per year (one-third of the total annual book depreciation of \$3,000). The partnership has a tax depreciation deduction of \$2,000 per year (10 percent of the \$20,000 tax basis in Property A). This \$2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of the third year, the book value of Property A is \$21,000 (\$30,000 initial book value less \$9,000 aggregate book depreciation) and the adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is \$7,000 (\$21,000 book value less \$14,000 adjusted tax basis).

(iv) On December 31, 1998, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized \$7,000 of gain under section 704(c)(1)(A) and § 1.704-3(b). Therefore, A recognizes \$7,000 of gain on the distribution of Property A to B.

**Example 3. Effect of remedial method.** (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A

contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in § 1.704-3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased to \$7,000, Property A1 is distributed to C in partial liquidation of C's interest in the partnership. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the \$2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of \$7,000 less \$5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of \$3,000 (\$10,000 original book value less \$7,000 current fair market value of the property). Book loss in the amount of \$2,000 would have been allocated equally between B and C. Under the remedial method, \$2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, \$2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized \$4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 (\$2,000 of section 704(c) recognized gain plus \$2,000 remedial gain). Therefore, A recognizes \$4,000 of gain on the distribution of Property A1 to C under this section.

(b) **Character of gain or loss—(1) General rule.** Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) **Example.** The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

**Example. Character of gain.** (i) On January 1, 1995, A and B form partnership AB. A contributes \$10,000 and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000, in exchange for a 25 percent interest in partnership capital and profits. B contributes \$60,000 cash for a 75 percent interest in partnership capital and profits.

(ii) On December 31, 1998, Property A is distributed to B in partial liquidation of B's interest in the partnership. Property A is used in a trade or business of B.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) on a sale of

Property A at the time of the distribution (the difference between the fair market value (\$10,000) and the adjusted tax basis (\$4,000) of the property at that time). Because Property A is not a capital asset in the hands of Partner B and B holds more than 50 percent of partnership capital and profits, the character of the gain on a sale of Property A to B would have been ordinary income under section 707(b)(2). Therefore, the character of the gain to A on the distribution of Property A to B is ordinary income.

(c) **Exceptions—(1) Property contributed on or before October 3, 1989.** Section 704(c)(1)(B) and this section do not apply to property contributed to the partnership on or before October 3, 1989.

(2) **Certain complete liquidations.** Section 704(c)(1)(B) and this section do not apply to a distribution of an interest in section 704(c) property to a partner other than the contributing partner in a complete liquidation of the partnership if—

(i) The contributing partner receives an interest in the contributed section 704(c) property; and

(ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner without regard to this paragraph (c)(2).

(3) **Section 708(b)(1)(B) termination.** Section 704(c)(1)(B) and this section do not apply to a deemed distribution of property caused by a termination of the partnership under section 708(b)(1)(B). See paragraph (a)(4)(iii) of this section for a special rule regarding a new five-year period for certain property deemed contributed to a new partnership following a termination of the partnership under section 708(b)(1)(B). See also § 1.737-2(a) for a similar rule in the context of section 737.

(4) **Example.** The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

**Example. Complete liquidation.** (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. Property B therefore has a