

payments that the taxpayer has received but not taken into income with respect to the contract. Under these rules, a partner accounting for a long-term contract under the CCM that incurs \$400 of allocable contract costs, receives \$500 of progress payments with respect to the contract, and the contributes the contract, but not the progress payments, to a partnership would be able to claim a \$400 basis in the partnership interest received. Without any adjustments, such an analysis would give rise to erroneous results.

For this reason, these proposed regulations, like the rules in the final section 460 regulations applicable to corporate step-in-the-shoes transactions, such as transactions described in section 351(a), require a partner that contributes a contract accounted for under a long-term contract method of accounting to a partnership to adjust the basis of the partnership interest received. Specifically, the proposed regulations require the partner to increase the basis of the partnership interest by the amount of gross receipts that the partner has recognized under the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. If the decrease exceeds the partner's basis in the partnership interest, then the partner must recognize income equal to the excess. To ensure that the partnership is not taxed again on any income taken into account by the partner under this rule, the proposed regulations require the partnership to reduce its total contract price (or gross contract price) by the amount of income recognized by the contributing partner.

2. Built-In Income and Loss

Section 704(c) generally provides that income, gain, loss, or deduction attributable to property that is contributed to a partnership must be allocated to the contributing partner. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. These proposed regulations provide that the principles of section 704(c) and § 1.704-3 apply to allocations of income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership (or that is revalued by a partnership under § 1.704-1(b)(2)(iv)(f)). The proposed regulations provide that the partnership must apply section 704(c) to such income or loss in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

Under the proposed regulations, the amount of built-in income or built-in loss attributable to a contributed contract that is subject to section 704(c) is determined as follows. First, the contributing partner must take into account any income or loss required under the step-in-the-shoes rules for the period ending on the date of the contribution. Second, the partnership determines the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied the step-in-the-shoes rules, but before the contribution to the partnership. Finally, this amount is reduced by the amount of income, if any, that the contributing partner is required to recognize as a result of the contribution.

3. Transfer of a Partnership Interest

The transfer of an interest in a partnership engaged in a contract accounted for under a long-term contract method of accounting is a step-in-the-shoes transaction. Section 741 provides that gain or loss recognized on the sale or exchange of an interest in a partnership is considered as gain or loss from a capital asset, except as provided in section 751. 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 any part of the partner's interest in the partnership attributable to unrealized receivables (as defined in section 751(c)) or inventory items (as defined in section 751(d)) of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset. In Rev. Rul. 79-51 (1979-1 C.B. 225), the IRS addressed a transaction in which a partner sold the partner's entire interest in a partnership holding partially completed contracts, the income from which was being accounted for under the CCM. The IRS ruled that the value of the contracts at the time of sale are unrealized receivables for purposes of section 751(c).

Consistent with Rev. Rul. 79-51, the proposed regulations provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of section 751(c). The amount of ordinary income or loss attributable to a contract is the amount of income or loss that the partnership would take into account under the constructive completion rules if, at the time of a

transfer of a partnership interest, the partnership disposed of the contract for its fair market value in a constructive completion transaction.

4. Adjustments to the Basis of Partnership Property

Section 743(b) allows a partnership to adjust the basis of partnership property in the case of a transfer of an interest in the partnership by sale or exchange or on the death of a partner. If all or part of a basis adjustment under section 743(b) is allocated to a contract accounted for under a long-term contract method of accounting, the proposed regulations provide that the adjustment shall reduce or increase, as the case may be, the transferee partner's distributive share of income or loss from the contract. In the case of a contract accounted for under the CCM, the basis adjustment is taken into account in the year in which the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, the portion of the basis adjustment that is recovered in each taxable year of the partnership must be determined by the partnership in a manner that reasonably accounts for the adjustment over the remaining term of the contract. Similar rules apply if all or part of an adjustment to the basis of partnership property under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting.

5. Closing of the Books

Generally, under the step-in-the-shoes rules, an old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. This rule differs from § 1.706-1(c)(2)(ii), which provides that, if a partner's interest in the partnership terminates during the taxable year, the partnership may determine the partner's distributive share of partnership items either by closing the partnership's books as of the termination date or by prorating the partnership's income for the entire year between the pre- and post-termination periods.

Consistent with § 1.706-1(c)(2)(ii), these regulations generally provide that upon the transfer or liquidation of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting, the step-in-the-shoes rules apply to a