

to the basis adjustment rule of paragraph (k)(3)(iv)(A) of this section).

(2) *Basis in contract.* The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section will be computed under section 362, section 334, or section 723, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(2).

(C) *Definition of old taxpayer and new taxpayer for certain partnership transactions.* For purposes of paragraphs (k)(3)(ii), (iii) and (iv) of this section, in the case of a transaction described in paragraph (k)(3)(i)(I) of this section, the partner contributing the contract to the partnership is treated as the old taxpayer, and the partnership receiving the contract from the partner is treated as the new taxpayer.

(v) *Special rules relating to certain partnership transactions—(A) Section 704(c)—(1) Contributions of contracts.* The principles of sections 704(c) and § 1.704–3 apply to income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership. 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 paragraph (k)(3)(ii)(A) of this section for the period ending on the date of the contribution. Second, the partnership must determine 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 paragraph (k)(3)(ii)(A) of this section, 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.

(2) *Revaluations of partnership property.* The principles of section 704(c) and § 1.704–3 apply to allocations of income or loss with respect to a long-term contract that is

revalued by a partnership under § 1.704–1(b)(2)(iv)(f). The amount of built-in income or built-in loss attributable to such a contract is equal to the amount of income or loss that would be taken into account if, immediately before the revaluation, the contract were disposed of for its fair market value in a constructive completion transaction.

(3) *Allocation methods.* In the case of a contract accounted for under the CCM, any built-in income or loss under section 704(c) is taken into account in the year the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, any built-in income or loss under section 704(c) must be taken into account in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

(B) *Basis adjustments under sections 743(b) and 734(b).* For purposes of §§ 1.743–1(d), 1.755–1(b), and 1.755–1(c), the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if, at the time of the sale of a partnership interest or the distribution to a partner, the partnership disposed of the contract for its fair market value in a constructive completion transaction. If all or part of the transferee's basis adjustment under section 743(b) or the partnership's basis adjustment under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting, the basis adjustment shall reduce or increase, as the case may be, the affected party's 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 that 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.

(C) *Cross reference.* See paragraph (k)(2)(iv)(E) of this section for rules relating to the application of section 751 to the transfer of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting.

(D) *Exceptions to step-in-the-shoes rules.* Upon a contribution described in

paragraph (k)(3)(i)(J) of this section, a transfer described in paragraph (k)(3)(i)(K) of this section, or a distribution described in paragraph (k)(3)(i)(L) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. In these cases, the partnership is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transactions, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period under a reasonable method complying with section 706.

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Example 9. Constructive completion—PCM—distribution of contract by partnership—(i) Facts. In Year 1, W, X, Y, and Z each contribute \$100,000 to form equal partnership PRS. In Year 1, PRS enters into a contract. The total contract price is \$1,000,000 and the estimated total allocable contract costs are \$800,000. In Year 1, PRS incurs costs of \$600,000 and receives \$650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, PRS distributes the contract to X in liquidation of X's interest. PRS incurs no costs and receives no progress payments in Year 2 prior to the distribution. At the time of the distribution, PRS's only asset other than the long-term contract and the partially constructed property is \$450,000 cash (\$400,000 initially contributed and \$50,000 in excess progress payments). The fair market value of the contract is \$150,000. Pursuant to the distribution, X assumes PRS's contract obligations and rights. In Year 2, X incurs additional allocable contract costs of \$50,000. X correctly estimates at the end of Year 2 that X will have to incur an additional \$75,000 of allocable contract costs in Year 3 to complete the contract (rather than \$150,000 as originally estimated by PRS). Assume that X properly accounts for the contract under the PCM, that PRS has no income or loss other than income or loss from the contract, and that PRS has an election under section 754 in effect in Year 2.

(ii) *Tax consequences to PRS.* For Year 1, PRS reports receipts of \$750,000 (the completion factor multiplied by total contract