

price (\$600,000/\$800,000 x \$1,000,000)) and costs of \$600,000, for a profit of \$150,000, which is allocated equally among W, X, Y, and Z (\$37,500 each). Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract (\$150,000) is treated as the amount realized from the transaction. For purposes of applying the PCM in Year 2, the total contract price is \$800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction (\$650,000 + \$150,000)) and the total allocable contract costs are \$600,000. Thus, in Year 2 PRS reports receipts of \$50,000 (total contract price minus receipts already reported (\$800,000—\$750,000)), and costs incurred in year 2 of \$0, for a profit of \$50,000. Under paragraph (k)(2)(iv)(B) of this section, this profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is \$12,500.

(iii) *Tax consequences to X.* X's basis in its interest in PRS immediately prior to the distribution is \$150,000 (X's \$100,000 initial contribution, increased by \$37,500, X's distributive share of Year 1 income, and \$12,500, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to \$150,000 (the partnership's allocable contract costs, \$600,000, increased by the amount of income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), \$200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, \$650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is \$150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract (including the uncompleted property) is treated as consideration paid by X that is allocable to the contract. X's total contract price is \$200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract (\$350,000—\$150,000)). For Year 2, X reports receipts of \$80,000 (the completion factor multiplied by the total contract price [(\$50,000/\$125,000) x \$200,000]) and costs of \$50,000 (the costs incurred after the distribution of the contract), for a profit of \$30,000. For Year 3, X reports receipts of \$120,000 (the total contract price minus receipts already reported (\$200,000—\$80,000)) and costs of \$75,000, for a profit of \$45,000.

(iv) *Section 734(b).* Because X's basis in the contract (including the uncompleted property) immediately after the distribution, \$150,000, is equal to PRS's basis in the contract (including the uncompleted property) immediately prior to the distribution, a basis adjustment under section 734(b) is not required.

*Example 10. Constructive completion—CCM—distribution of contract by*

*partnership—(i) Facts.* The facts are the same as in *Example 9*, except that PRS and X properly account for the contract under the CCM.

(ii) *Tax consequences to PRS.* PRS reports no income or costs from the contract in Year 1. Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract (\$150,000) is treated as the amount realized from the transaction. For purposes of applying the CCM in Year 2, the gross contract price is \$800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction (\$650,000 + \$150,000)) and the total allocable contract costs are \$600,000. Thus, in Year 2 PRS reports profits of \$200,000 (\$800,000 – \$600,000). This profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is \$50,000.

(iii) *Tax consequences to X.* X's basis in its interest in PRS immediately prior to the distribution is \$150,000 (\$100,000 initial contribution, increased by \$50,000, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to \$150,000 (the partnership's allocable contract costs, \$600,000, increased by the amount of cumulative taxable income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), \$200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, \$650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is \$150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract is treated as consideration paid by X that is allocable to the contract. Under the CCM, X reports no gross receipts or costs in Year 2. For Year 3, the completion year, X reports its gross contract price of \$200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract (\$350,000 – \$150,000)) and its total allocable contract costs of \$125,000 (the allocable contract costs that X incurred to complete the contract (\$50,000 + \$75,000)), for a profit of \$75,000.

(iv) *Section 734(b).* The results under section 734(b) are the same as in *Example 9*.

*Example 11. Step-in-the-shoes—PCM—contribution of contract to partnership—(i) Facts.* In Year 1, X enters into a contract that X properly accounts for under the PCM. The total contract price is \$1,000,000 and the estimated total allocable contract costs are \$800,000. In Year 1, X incurs costs of \$600,000 and receives \$650,000 in progress payments under the contract. Under the contract, X 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. In Year 2, X contributes the contract (including the uncompleted property) with a basis of \$0 and \$125,000 of cash to partnership PRS in exchange for a one-fourth partnership interest. X incurs costs of \$10,000, and receives no progress payments in Year 2 prior to the contribution of the contract. X and the other three partners of PRS share equally in its capital, profits, and losses. The parties determine that, at the time of the contribution, the fair market value of the contract is \$160,000. Following the contribution in Year 2, PRS incurs additional allocable contract costs of \$40,000. PRS correctly estimates at the end of Year 2 that it 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). (ii) *Tax consequences to X.* For Year 1, X reports receipts of \$750,000 (the completion factor multiplied by the total contract price (\$600,000/\$800,000 x \$1,000,000)) and costs of \$600,000, for a profit of \$150,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i)(I) of this section, X is not treated as completing the contract in Year 2. Under paragraph (k)(3)(ii)(A) of this section, for Year 2, X reports receipts of \$12,500 (the completion factor multiplied by the total contract price (\$610,000/\$800,000 x \$1,000,000)), \$762,500, decreased by receipts already reported, \$750,000 and costs of \$10,000, for a profit of \$2,500. Under section 722, X's initial basis in its interest in PRS is \$125,000. Pursuant to paragraph (k)(3)(iv)(A)(1) of this section, X must increase its basis in its interest in PRS by the amount of gross receipts X recognized under the contract, \$762,500, and reduce its basis by the amount of gross receipts X received under the contract, the \$650,000 in progress payments. Accordingly, X's basis in its interest in PRS is \$237,500.

(iii) *Tax consequences to PRS.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, PRS must account for the contract using the same methods of accounting used by X prior to the transaction. The total contract price is the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and PRS. For Year 2, PRS reports receipts of \$134,052 (the completion factor multiplied by the total contract price