

$[(\$650,000/\$725,000) \times \$1,000,000]$ , \$896,552, decreased by receipts reported by X, \$762,500) and costs of \$40,000, for a profit of \$94,052. For Year 3, PRS reports receipts of \$103,448 (the total contract price minus prior year receipts (\$1,000,000 – \$896,552)) and costs of \$75,000, for a profit of \$28,448.

(iv) *Section 704(c)*. The principles of section 704(c) and § 1.704–3 apply to allocations of income or loss with respect to the contract contributed by X. In this case, the amount of built-in income that is subject to section 704(c) is 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. In a constructive completion transaction, the total contract price would be \$810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale (\$650,000 + \$160,000)). X would report receipts of \$47,500 (total contract price minus receipts already reported (\$810,000 – \$762,500)) and costs of \$0, for a profit of \$47,500. Thus, the amount of built-in income that is subject to section 704(c) is \$47,500. The partnership must apply section 704(c) to this income in a manner that reasonably accounts for the income over the remaining term of the contract. For example, in Year 2, PRS could allocate \$26,810 to X under section 704(c) (the amount of built-in income, \$47,500, multiplied by a fraction, the numerator of which is the completion factor for the year, \$650,000/\$725,000, less the completion factor for the prior year, \$610,000/\$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the event creating the section 704(c) income or loss, \$610,000/\$800,000). The remaining \$67,242 would be allocated equally among all of the partners. In Year 3, the completion year, PRS could allocate \$20,690 to X under section 704(c)  $(\$47,500 \times [(\$725,000/\$725,000 - \$650,000/\$725,000)/(100 \text{ percent} - \$610,000/\$800,000)])$ . The remaining \$7,758 would be allocated equally among all the partners.

*Example 12. Step-in-the-shoes—CCM—contribution of contract to partnership—(i) Facts.* The facts are the same as in *Example 11*, except that X and PRS properly account for the contract under the CCM, and X has a basis of \$610,000 in the contract (including the uncompleted property).

(ii) *Tax consequences to X.* X reports no income or costs from the contract in Years 1 or 2. X is not treated as completing the contract in Year 2. Under section 722, X's initial basis in its interest in PRS is \$735,000 (the sum of \$125,000 cash and X's basis of \$610,000 in the contract (including the uncompleted property)). Pursuant to paragraph (k)(3)(iv)(A)(i)(ii) of this section, X must reduce its basis in its interest in PRS by the amount of gross receipts X received under the contract, or \$650,000. Accordingly, X's basis in its interest in PRS is \$85,000.

(iii) *Tax consequences to PRS.* PRS must account for the contract using the same methods of accounting used by X prior to the

transaction. Under the CCM, PRS reports no gross receipts or costs in Year 2. For Year 3, the completion year, PRS reports its gross contract price of \$1,000,000 (the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract), and total allocable contract costs of \$725,000 (the allocable contract costs of X and PRS), for a profit of \$275,000.

(iv) *Section 704(c)*. In this case, the amount of built-in income that is subject to section 704(c) is 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. In a constructive completion transaction, X would report its gross contract price of \$810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale (\$650,000 + \$160,000)) and its total allocable contract costs of \$610,000, for a profit of \$200,000. Thus, the amount of built-in income that is subject to section 704(c) is \$200,000. Out of PRS's income of \$275,000, in Year 3, \$200,000 must be allocated to X under section 704(c), and the remaining \$75,000 is allocated equally among all of the partners.

*Example 13. Step-in-the-shoes—PCM—transfer of a partnership interest—(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 payment or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, W transfers W's interest in PRS to T for \$150,000. Assume that \$10,000 of PRS's Year 2 costs are incurred prior to the transfer, \$40,000 are incurred after the transfer; and that PRS receives no progress payments in Year 2. Also assume that the fair market value of the contract on the date of the transfer is \$160,000, that PRS closes its books with respect to the contract under section 706 on the date of the transfer, and that 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) *Income reporting for period ending on date of transfer.* For Year 1, PRS reports receipts of \$750,000 (the completion factor multiplied by total contract price (\$600,000/\$800,000  $\times$  \$1,000,000)) and costs of \$600,000, for a profit of \$150,000. This profit is allocated equally among W, X, Y, and Z (\$37,500 each). Under paragraph (k)(3)(ii)(A) of this section, for the part of Year 2 ending on the date of the transfer of W's interest, PRS reports receipts of \$12,500 (the completion factor multiplied by the total

contract price (\$610,000/\$800,000  $\times$  \$1,000,000) minus receipts already reported (\$750,000)) and costs of \$10,000 for a profit of \$2,500. This profit is allocated equally among W, X, Y, and Z (\$625 each).

(iii) *Income reporting for period after transfer.* PRS must continue to use the PCM. For the part of Year 2 beginning on the day after the transfer, PRS reports receipts of \$134,052 (the completion factor multiplied by the total contract price decreased by receipts reported by PRS for the period ending on the date of the transfer  $[(\$650,000/\$725,000 \times \$1,000,000) - \$762,500]$ ) and costs of \$40,000, for a profit of \$94,052. This profit is shared equally among T, X, Y, and Z (\$23,513 each). For Year 3, PRS reports receipts of \$103,448 (the total contract price minus prior year receipts (\$1,000,000 – \$896,552)) and costs of \$75,000, for a profit of \$28,448. The profit for Year 3 is shared equally among T, X, Y, and Z (\$7,112 each).

(iv) *Tax Consequences to W.* W's amount realized is \$150,000. W's adjusted basis in its interest in PRS is \$138,125 (\$100,000 originally contributed, plus \$37,500, W's distributive share of PRS's Year 1 income, and \$625, W's distributive share of PRS's Year 2 income prior to the transfer). Accordingly, W's income from the sale of W's interest in PRS is \$11,875. Under paragraph (k)(2)(iv)(E) of this section, for purposes of section 751(a), the amount of ordinary income attributable to the contract is determined as follows. First, the partnership must determine the amount of income or loss from the contract that is allocated under section 706 to the period ending on the date of the sale (\$625). Second, the partnership must determine 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 the contract were disposed of for its fair market value in a constructive completion transaction. Because PRS closed its books under section 706 with respect to the contract on the date of the sale, this calculation is treated as occurring immediately after the partnership has applied paragraph (k)(3)(ii)(A) of this section on the date of the sale. In a constructive completion transaction, the total contract price would be \$810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale (\$650,000 + \$160,000)). PRS would report receipts of \$47,500 (total contract price minus receipts already reported (\$810,000 – \$762,500)) and costs of \$0, for a profit of \$47,500. Thus, the amount of ordinary income attributable to the contract is \$47,500, and W's share of that income is \$11,875. Thus, under § 1.751–1(a), all of W's \$11,875 of income from the sale of W's interest in PRS is ordinary income.

(v) *Tax Consequences to T.* T's adjusted basis for its interest in PRS is \$150,000. Under § 1.743–1(d)(2), the amount of income that would be allocated to T if the contract were disposed of for its fair market value (adjusted to account for income from the contract for the portion of PRS's taxable year that ends on the date of the transfer) is \$11,875. Under § 1.743–1(b), the amount of T's basis adjustment under section 743(b) is