

640, and 660) to the Dockets Management Branch (address above). Two copies of any comments are to be submitted, except that individuals may submit one copy. Comments are to be identified with the appropriate docket number found in brackets in the heading of this document. Received comments may be seen in the office above between 9 a.m. and 4 p.m., Monday through Friday.

Transcripts of the public meeting may be requested in writing from the Freedom of Information Office (HFI-35), Food and Drug Administration, rm. 12A-16, 5600 Fishers Lane, Rockville, MD 20857, approximately 15 working days after the meeting, at a cost of 10 cents per page. The transcript of the public meeting and copies of information and comments submitted to the meeting record will be available for examination at the Dockets Management Branch (address above) approximately 15 working days after the meeting, between 9 a.m. and 4 p.m., Monday through Friday.

Dated: January 4, 1995.

William K. Hubbard,

Interim Deputy Commissioner for Policy.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[PS-76-92]; [PS-51-93]

RIN 1545-AR48; RIN 1545-AR93

Recognition of Gain or Loss by Contributing Partner on Distribution of Contributed Property or Other Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the recognition of gain or loss on certain distributions of contributed property by a partnership under section 704(c)(1)(B) of the Internal Revenue Code of 1986 (Code). This document also contains proposed regulations relating to the recognition of gain on certain distributions to a contributing partner under section 737. Changes to the applicable law were made by the Revenue Reconciliation Act of 1989 and the Energy Policy Act of 1992. The proposed regulations affect partnerships and their partners and are necessary to

provide guidance for complying with the applicable tax law.

DATES: Written comments must be received by April 10, 1995. Requests to speak (with outlines of oral comments) at a public hearing scheduled for June 19, 1995, at 10 a.m. must be received by May 29, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-76-92; PS-51-93), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC. 20044. In the alternative, submissions may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to: CC:DOM:CORP:T:R (PS-76-92; PS-51-93), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. The public hearing has been scheduled to be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations, Stephen J. Coleman, (202) 622-3060; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Introduction

This document proposes to add new §§ 1.704-4, 1.737-1, 1.737-2, 1.737-3, 1.737-4, and 1.737-5 to the Income Tax Regulations (26 CFR part 1) under sections 704(c)(1)(B), 704(c)(2), and 737 of the Code.

Background

Section 704(c)(1)(A) of the Internal Revenue Code (Code) requires that gain or loss with respect to property contributed to a partnership by a partner be shared among the partners so as to take into account any built-in gain or loss in the property at the time of the contribution. Prior to its amendment by the Revenue Reconciliation Act of 1989 (1989 Act), section 704(c) did not require the recognition of built-in gain or loss by a contributing partner on a distribution of contributed property by the partnership. The 1989 Act added sections 704(c)(1)(B) and 704(c)(2) to the Code. Section 704(c)(1)(B) provides that in the case of a distribution of contributed property to another partner within five years of its contribution to the partnership, the contributing partner must recognize gain or loss in an amount equal to the gain or loss the partner would have been allocated under section 704(c)(1)(A) on a sale of the property by the partnership at its fair market value at the time of the distribution. Section 704(c)(2) provides

for an exception for distributions of certain like-kind property. The legislative history of the 1989 Act indicates that Congress intended section 704(c)(1)(B) to eliminate the inconsistent treatment of sales and distributions by a partnership and thereby prevent partners from circumventing the rule requiring pre-contribution gain or loss on contributed property to be allocated to the contributing partner by distributing the property to another partner. H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 406 (1989).

Prior to the enactment of the Energy Policy Act of 1992 (1992 Act), a partner who contributed appreciated property to a partnership did not recognize gain on a distribution to the distributee partner of partnership property other than money. The 1992 Act added section 737 to the Code to require a contributing partner to recognize gain to the extent of the lesser of (i) the net pre-contribution gain on property contributed to the partnership by the partner, or (ii) the excess of the value of the distributed property over the adjusted basis of the partner's interest in the partnership. H.R. Rep. No. 102-1018, 102d Cong., 2d Sess. 428 (1992).

Explanation of Provisions

A. Overview

Section 704(c)(1)(B) generally requires a contributing partner to recognize gain or loss when the property contributed by that partner is distributed to another partner within five years of its contribution to the partnership. Section 737 generally requires a contributing partner to recognize gain when the partner receives, within five years of the contribution, a distribution of other property with a fair market value in excess of the partner's adjusted basis in the partnership. Both sections apply only to distributions made to a partner in the partner's capacity as a partner. Section 704(c)(1)(B) and section 737 do not apply to transactions or distributions in which the partner is not acting in the capacity of a partner (e.g., transactions or distributions subject to section 707(a) or section 751(b)).

The proposed regulations provide rules for determining when section 704(c)(1)(B) and section 737 apply and the amount of gain or loss that must be recognized by the contributing partner under the applicable section. The proposed regulations also provide rules for determining the character of such gain or loss and for making the necessary basis adjustments. The proposed regulations contain several exceptions that are based on the

statutory language and the legislative history. The proposed regulations also contain special rules dealing with specific situations such as the partnership's exchange of the contributed property for other property in a nonrecognition transaction and the transfer of a contributing partner's interest in the partnership. The proposed regulations also provide for coordination between section 704(c)(1)(B) and section 737 in situations in which both sections may apply to a distribution or distributions by a partnership. In fashioning these specific rules, the proposed regulations focus on the purpose of section 704(c)(1)(B) and section 737, rather than simply relying on the literal language of the provisions in situations that would be inconsistent with the underlying purpose of the provisions.

The proposed regulations under section 704(c)(1)(B) and section 737 contain an anti-abuse rule providing that the rules of the applicable section must be applied in a manner consistent with its purpose. Accordingly, the anti-abuse rules contained in the proposed regulations provide that, if a principal purpose of a transaction is to achieve a tax result inconsistent with the purpose of the applicable section, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with such purpose.

Whether a tax result is inconsistent with the purpose of the applicable section is determined based on all the facts and circumstances. The proposed regulations also provide examples illustrating how these anti-abuse rules apply.

B. Section 704(c)(1)(B)

In General

Under the proposed regulations, the contributing partner must recognize gain or loss on a distribution of the contributed property to another partner within five years of its contribution to the partnership. The amount of gain or loss recognized is the amount that would have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the distributee partner at its fair market value at the time of the distribution. The amount of gain or loss recognized may vary depending on the particular method used by the partnership in making allocations under section 704(c)(1)(A) and § 1.704-3 because the amount of remaining built-in gain or loss may vary depending on the particular method of

allocation adopted. In addition, because the property is treated as having been sold by the partnership to the distributee partner, the proposed regulations provide that any loss that would have been disallowed under section 707(b)(1) if the distributed property had actually been sold to the distributee partner is disallowed.

Five-Year Period

Section 704(c)(1)(B) applies only to property distributed within five years of its contribution to the partnership. The proposed regulations provide that a new five-year period begins for property deemed contributed to a new partnership following a termination of the partnership under section 708(b)(1)(B), but only to the extent that the pre-termination gain or loss on such property was not already required to be allocated to the original contributor under section 704(c)(1)(A) and § 1.704-3. The effect of this provision is to begin a new five-year period for post-contribution changes in the value of partnership property whenever there is a termination of the partnership under section 708(b)(1)(B). This provision is consistent with the legislative history of section 704(c)(1)(B).

Character of Gain or Loss

The proposed regulations provide that the character of the contributing partner's gain or loss is the same as the character that would have been recognized if the property had been sold by the partnership to the distributee partner. Thus, if the distributee partner holds more than a 50 percent capital or profits interest in the partnership, any gain recognized by the contributing partner may be ordinary income under section 707(b)(2).

Exceptions and Special Rules

The proposed regulations provide that section 704(c)(1)(B) does not apply to (i) a distribution of property contributed to the partnership on or before October 3, 1989, or (ii) a distribution of property in connection with a termination of the partnership under section 708(b)(1)(B). The proposed regulations also provide that section 704(c)(1)(B) does not apply to a distribution of a portion of contributed property to a noncontributing partner in a complete liquidation of the partnership if a portion of the contributed property is distributed to the contributing partner and that portion has unrecognized gain or loss in the hands of the contributing partner, determined immediately after the distribution, at least equal to the built-in gain or loss that would have been allocated to the contributing

partner under section 704(c)(1)(A) on a sale of the contributed property by the partnership at the time of the distribution. This exception is consistent with the purpose of section 704(c)(1)(B) to prevent the shifting of built-in gain or loss among partners because no shift has occurred in this limited situation.

The proposed regulations provide that property received by a partnership in exchange for contributed property in a nonrecognition transaction is treated as the contributed property. This result is consistent with the rule under § 1.704-3(a)(8) of the regulations. The proposed regulations also provide that the transferee of a contributing partner is treated as the contributing partner to the extent of the built-in gain or loss allocated to the transferee partner. The gain or loss allocated to the transferee partner may be offset, however, by the basis adjustments to partnership property by a partnership with a section 754 election in effect. This result is consistent with the result under § 1.704-3(a)(7) of the regulations.

The proposed regulations also provide a special rule under section 704(c)(2) for cases in which the contributing partner receives like-kind property no later than the earlier of: (1) 180 days following the date of the distribution of contributed property to another partner, or (2) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the other partner. Under this rule, the contributing partner's gain that otherwise would be recognized under section 704(c)(1)(B) is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner. The amount of the built-in gain or loss is determined by reference to the contributing partner's basis in the property immediately after the distribution under section 732(a) or (b). The proposed regulations provide that the basis in the distributed like-kind property in this situation is determined without taking into account any increase in the basis of the contributing partner's partnership interest for any gain recognized under section 704(c)(1)(B). This special rule implements the statutory objective of not requiring gain or loss on distributions where gain or loss would not have been recognized outside of a partnership. When gain or loss is not recognized in exchanges of like-kind property outside of partnerships, the built-in gain or loss on the exchanged property is generally preserved in the property received in the exchange. To the extent that this built-in gain or loss

is not preserved in the case of a distribution of property by the partnership, the exception does not apply.

Basis Adjustments

The contributing partner's basis in the partnership interest and the partnership's basis in the distributed property are increased or decreased by the amount of gain or loss recognized by the contributing partner. These adjustments are taken into account in determining (1) the noncontributing partner's basis in the property distributed to that partner, (2) the contributing partner's basis in any property distributed to that partner in the same transaction (except to the extent that the distributed property is like-kind property subject to the special rule discussed above), (3) the basis adjustments, if any, to partnership property by a partnership with a section 754 election in effect, and (4) the amount of the contributing partner's gain under section 731 or section 737 on a related distribution of money or property, respectively, to the contributing partner.

C. Section 737

In General

Under the proposed regulations, a partner that contributes property with built-in gain to a partnership and receives a distribution of property other than money within five years of that contribution must recognize gain in an amount equal to the lesser of (1) the excess (if any) of the fair market value of the distributed property over the adjusted basis of the partner's interest in the partnership (excess distribution); or (2) the net precontribution gain of the partner.

Excess Distribution

In determining the amount of the excess distribution, the proposed regulations provide that the distributee partner's adjusted basis in the partnership interest is first adjusted for all basis adjustments resulting from the distribution subject to section 737 (for example, basis adjustments under section 752) and any basis adjustments resulting from any other distribution that is part of the same plan or arrangement (for example, basis adjustments required under sections 704(c)(1)(B) and 751(b)). Two basis adjustments, however, are not taken into account in determining whether there is an excess distribution: (1) the partner's basis is not increased for the gain recognized under section 737, and (2) is not decreased by the adjustment

required under section 733 for property distributed to the distributee partner in the transaction (other than property previously contributed to the partnership by the partner). The first exception is consistent with section 737(c)(1) and the second is necessary to prevent an inappropriate decrease in the partner's basis (and corresponding increase in the partner's gain) under section 737. The reduction in the partner's adjusted basis for a distribution of property previously contributed to the partnership by the partner is necessary to give effect to the statutory requirement that a distribution of previously contributed property not be taken into account in determining the amount of an excess distribution.

The proposed regulations also provide that, in determining the amount of an excess distribution, the fair market value of distributed property is not reduced by the amount of any liability assumed or taken subject to by the partner. The distributee partner's basis in the partnership interest, however, is increased by the amount of any liability assumed or taken subject to by the distributee partner and this increase is taken into account in determining the amount of the excess distribution. (The partner's basis is also adjusted for the decrease in the partner's share of partnership liabilities as a result of the distribution for this purpose.) As a result, the gross fair market value of the property will be offset by the basis increase in the partner's interest in the partnership under section 752 and, as a result, the amount of the excess distribution should be limited to the net value of the distributed property.

Net Precontribution Gain

The distributee partner's net precontribution gain is the net gain (if any) that the partner would have recognized under section 704(c)(1)(B) if the partnership had distributed to another partner all property contributed to the partnership by the distributee partner within five years of the date of the distribution. The amount of gain or loss that the distributee partner would recognize under section 704(c)(1)(B) is determined under the proposed regulations to section 704(c)(1)(B) contained in this notice.

The proposed regulations under section 737 provide special rules for determining the amount of the partner's net precontribution gain. Property contributed on or before October 3, 1989, is not included in determining the amount of net precontribution gain because net precontribution gain is determined by reference to section 704(c)(1)(B), and that section does not

apply to property contributed to the partnership on or before October 3, 1989.

Net precontribution gain is reduced as a result of a basis increase to the contributed property under section 734(b)(1)(A) to reflect gain recognized by the partner under section 731 on a distribution of money in the same plan or arrangement as the distribution of property subject to section 737. This reduction is appropriate because some or all of the precontribution gain is recognized by the contributing partner under section 731 on the distribution.

The proposed regulations also provide that a transferee partner succeeds to the transferor's net precontribution gain in an amount proportionate to the interest transferred. This provision is consistent with the provision in § 1.704-3(a)(7) (and § 1.704-4(d)(2) of the proposed regulations) requiring a transferee partner to succeed to all or a portion of the transferor's built-in gain or loss. The transferee partner, however, may not recognize the same amount of gain that the transferor partner would have recognized on a subsequent distribution because the transferee's basis in the partnership interest may be higher or lower than the transferor's basis, and the amount of gain allocated to the transferee partner under section 704(c)(1)(A) will be affected by any basis adjustment required under section 754.

Net precontribution gain is also reduced by the amount of gain recognized by the contributing partner under section 704(c)(1)(B) in a distribution of contributed property in a related distribution to another partner, and by the amount of gain that the partner would have recognized under section 704(c)(1)(B) on the distribution of contributed property to another partner but for the exception of section 704(c)(2). This reduction is necessary to avoid gain recognition under both section 704(c)(1)(B) and section 737 with respect to the same built-in gain. The reduction for gain not recognized as a result of the section 704(c)(2) exception only applies in situations where there is an actual distribution of contributed property to another partner.

Character of Gain

The character of the contributing partner's recognized gain is determined by reference to the character of the partner's net precontribution gain. The character of such gain is determined by netting all of the precontribution gains and losses according to the character that such property would have had on a sale by the partnership to an unrelated third party. The character of the

contributing partner's gain under section 737 is the same (and in the same proportion) as the character of any net positive amounts resulting from the netting of the precontribution gains and losses. Character for this purpose is broadly defined in the proposed regulations to include any item that the contributing partner would have been required to take into account separately under section 702(a) and § 1.702-1(a) had the partnership sold all the property contributed by that partner.

Because the contributed property is not actually transferred by the partnership to any particular partner, it is appropriate to treat the hypothetical dispositions by the partnership as occurring with an unrelated third party. As a result, the character conversion rule of section 707(b)(2) does not apply for purposes of determining the character of the distributee partner's gain. (Compare section 704(c)(1)(B) and § 1.704-4(b)(1) in which the character conversion rule does apply because the contributed property is actually distributed to another partner.)

Exceptions and Special Rules

The proposed regulations provide that section 737 does not apply to a deemed distribution of property on a termination of the partnership under section 708(b)(1)(B). As noted above (with respect to the discussion of the proposed regulations under section 704(c)(1)(B)), however, a new five-year period begins for property to the extent that the pre-termination gains and losses, if any, were not already required to be allocated to the original contributor under section 704(c)(1)(A) and § 1.704-3.

A transferee partner in a transfer that causes a termination under section 708(b)(1)(B) will generally not have any net precontribution gain immediately after the deemed formation of the new partnership. The basis of the property deemed contributed by the transferee partner to the new partnership is determined under section 732 and, as a result, the transferee partner may be treated as having contributed built-in gain and built-in loss property to the new partnership. These built-in gain and loss properties, however, should net to zero, assuming that the transferee partner's total basis in the properties is equal to their total fair market value. Section 737, however, does apply to the transferee partner and could result in gain recognition on a subsequent distribution if the distribution occurs at a time when the partner has a net precontribution gain. The transferee partner could have a net precontribution gain on a subsequent distribution if, for

example, the partnership sells some or all of the built-in loss property (that is deemed contributed by that partner to the new partnership in the section 708(b)(1)(B) termination) and retains the built-in gain property.

The proposed regulations also provide that section 737 does not apply to partnership mergers and similar transactions because the partners have merely converted their interests in the transferor partnership to an interest in the transferee partnership. As a result of this treatment, however, distributions by the transferee partnership are subject to section 737 to the same extent that distributions from the transferor partnership would have been subject to section 737.

Under the proposed regulations, section 737 applies to an incorporation of the partnership involving an actual distribution of property by the partnership to the partners followed by a contribution to a corporation. (As discussed below, however, section 737 does not apply to the extent that the property actually distributed to a partner was previously contributed to the partnership by that partner.) Section 737 does not apply to an incorporation of a partnership by methods not involving an actual distribution of partnership property to the partners, provided that the incorporation is followed by a complete liquidation of the partnership as part of the same plan or arrangement as the incorporation. Section 737 does not apply in these situations because the partners are converting their partnership interests into a stock interest in the corporation in a nonrecognition transaction and, under the rules of either sections 732 or 358, the built-in gain in a partner's partnership interest is preserved in the stock received by the contributing partner. This exception is similar to the general carry-over treatment provided in § 1.704-3(a)(8) for section 704(c) property exchanged in a nonrecognition transaction. Incorporation by means of a distribution of partnership property to the partners also results in the same conversion of a partnership interest into stock of a corporation, but that method of incorporation involves an actual distribution of property to the partners and the form of incorporation chosen by the partners governs the tax consequences of incorporation, including the application of section 737.

The proposed regulations provide that a related distribution of property previously contributed to the partnership by the distributee partner is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain.

The proposed regulations also provide, consistent with section 737(d)(1), for a limitation in the case of a distribution of a previously contributed interest in an entity. This limitation is intended to prevent a partner from avoiding section 737 by contributing an interest in an entity to the partnership and having the partnership contribute property to that entity, followed by a distribution of an interest in the entity to the contributing partner under the previously contributed property exception. This limitation does not apply to the extent that the property contributed by the partnership to the entity was contributed by the same partner that contributed the interest in the entity because, in that case, the distributee partner is receiving only a distribution of property that it previously contributed to the partnership.

The proposed regulations also provide that any property received by the partnership in exchange for previously contributed property is treated as previously contributed property to the extent such property is treated as section 704(c) property with regard to the contributing partner under § 1.704-3(a)(8). This provision is consistent with the general treatment of nonrecognition transactions involving section 704(c) property under § 1.704-3(a)(8).

Basis Adjustments

The contributing partner's basis in the partnership interest is increased by the amount of gain recognized by the partner. This increase is taken into account in determining a partner's basis in property received by that partner, but is not taken into account in determining the amount of gain recognized by the partner under section 737 or the amount of gain recognized under section 731 on any distribution of money in the same distribution as the distribution of property subject to section 737.

The partnership's basis in property contributed by the partner is also increased by the gain recognized by the partner. The basis increase is limited to built-in gain property held by the partnership after the distribution with the same character as the character of the gain recognized by the contributing partner under section 737. No basis increase is allocated to any previously contributed property that is part of the distribution to which section 737 applied. This previously contributed property is not taken into account in determining the amount of net precontribution gain and therefore it is not appropriate to increase the basis of that property. There is also no basis increase to any property distributed to another partner in a related distribution

to which section 704(c)(1)(B) applies. The basis in the distributed property in that case will be increased or decreased for any gain or loss recognized by the contributing partner under section 704(c)(1)(B) and therefore should not be adjusted for gain recognized under section 737.

The basis increase is allocated to built-in gain property with the same character as the character of the gain recognized by the partner. The amount of the basis increase allocated to property of a particular character is allocated to the property in the order contributed to the partnership, starting with the earliest contributed property. This ordering rule preserves the effect of the five-year rule to the extent possible. Allocating the adjustment to all property of a similar character based on any other rule would reduce the net precontribution gain attributable to later-contributed property before such gain was entirely eliminated on earlier contributed property.

Any increase to the adjusted tax basis of partnership property under the proposed regulations is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

Proposed Effective Date

These regulations are proposed to apply to distributions of property by a partnership to a partner on or after January 9, 1995.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and

eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 19, 1995, at 10 a.m. in the auditorium of the Internal Revenue Building. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 10, 1995 and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 22, 1995.

A period of 10 minutes will be allotted for each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * *
Section 1.704-4 also issued under 26 U.S.C. 704(c) * * *

Par. 2. Section 1.704-4 is added to read as follows:

§ 1.704-4 Distribution of contributed property.

(a) *Determination of gain*—(1) *In general.* A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership, in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and

§ 1.704-3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See § 1.704-3(a)(3)(i) for a definition of section 704(c) property.

(2) *Transactions to which section 704(c)(1)(B) applies.* Section 704(c)(1)(B) and this section apply only to a distribution that is properly characterized as a distribution to a partner acting in the capacity of a partner within the meaning of section 731 and section 737. Section 704(c)(1)(B) and this section do not apply to a transaction or distribution that is subject to provisions other than section 731(a) or section 737 (for example, a transaction or distribution subject to sections 707(a), 736(a), or 751(b)).

(3) *Fair market value of property.* The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) *Determination of five-year period*—(i) *General rule.* The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) begins a new five-year period for each partner with respect to the built-in gain and built-in loss property that the partner is deemed to recontribute to a new partnership following the termination, but only to the extent that the pre-termination built-in gain or loss, if any, on such property was not already required to be allocated to the original contributor under section 704(c)(1)(A) and § 1.704-3. See § 1.704-3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property.

(5) *Examples.* The following examples illustrate the rules of this paragraph (a). 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 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

built-in gain of \$10,000 at the time of contribution.

(ii) On December 31, 1998, the partnership completely liquidates when the fair market value of Property A has not changed, but the fair market value of Property B has increased to \$40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property B. This interest in Property B has a fair market value of \$10,000 to A, reflecting the fact that A was entitled to 50 percent of the \$20,000 post-contribution appreciation in Property B. The partnership distributes to B a 75 percent interest in Property B with a fair market value of \$30,000. B's basis in this portion of Property B is \$10,000 under section 732(b). As a result, B has a built-in gain of \$20,000 in this portion of Property B immediately after the distribution (\$30,000 fair market value less \$10,000 adjusted tax basis). This built-in gain is greater than the \$10,000 of built-in gain in Property B at the time of contribution to the partnership. B therefore does not recognize any gain on the distribution of a portion of Property B to A under this section.

(d) *Special rules*—(1) *Nonrecognition transactions*. Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the property received is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.737-2(d)(3) for a similar rule in the context of section 737.

(2) *Transfers of a partnership interest*. The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704-3(a)(7).

(3) *Distributions of like-kind property*. If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-

kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same plan or arrangement and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section.

(4) *Example*. The following example illustrates the rules of this paragraph (d). 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. Distribution of like-kind property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of \$8,000. The fair market value of Property X subsequently increases to \$10,000.

(ii) On December 31, 1998, Property A is distributed to B in partial liquidation of B's interest in the partnership. At the same time, Property X is distributed to A in partial liquidation of A's interest in the partnership. A's basis in Property X is \$8,000 under section 732(a)(1). A therefore has \$2,000 of built-in gain in Property X (\$10,000 fair market value less \$8,000 adjusted tax basis).

(iii) A would generally recognize \$10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value (\$20,000) of the property and its adjusted tax basis (\$10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only \$8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) *Basis adjustments*—(1) *Contributing partner's basis in the partnership interest*. The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same plan or arrangement as the distribution of the contributed property, other than like-

kind property described in paragraph (d)(3) of this section (pertaining to the special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same plan or arrangement as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see § 1.737-3(a).

(2) *Partnership's basis in partnership property*. The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see § 1.737-3(b).

(3) *Section 754 adjustments*. The basis adjustment to partnership property made pursuant to paragraph (e)(2) of this section is not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See § 1.737-3(c)(4) for a similar rule in the context of section 737.

(4) *Example*. The following example illustrates the rules of this paragraph (e). 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. Basis adjustment. (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. B and C each contribute \$20,000 cash.

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

(iii) Under paragraph (a) of this section, A recognizes \$6,000 of gain on the distribution of Property A because that is the amount of gain that would have been allocated to A under section 704(c)(1)(A) and § 1.704-3 on

a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A (\$10,000) less its adjusted tax basis at the time of distribution (\$4,000)). The adjusted tax basis of A's partnership interest is increased from \$14,000 to \$20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from \$4,000 to \$10,000 immediately prior to its distribution to B. B's adjusted tax basis in Property A is therefore \$10,000 under section 732(a)(1).

(f) *Anti-abuse rule—(1) In general.* The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See § 1.737-4 for an anti-abuse rule and examples in the context of section 737.

(2) *Examples.* The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. 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 1. Distribution in substance made within five-year period; results inconsistent with the purpose of section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B and C each contributes \$10,000 cash.

(ii) On December 31, 1998, the partners tentatively agree to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, A would recognize \$9,000 of gain under section 704(c)(1)(B), the difference between the \$10,000 fair market value and the \$1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five

years before December 31, 1998. On becoming aware of this potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are allocated to B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are allocated to A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 1* that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of \$9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

Example 2. Suspension of five-year period in manner consistent with the purpose of section 704(c)(1)(B). (i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes \$10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes

cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquirer of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for \$10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquirer of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of \$9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

Par. 3. Sections 1.737-1, 1.737-2, 1.737-3, 1.737-4, and 1.737-5 are added under the heading "Distributions by a Partnership" to read as follows:

§ 1.737-1 Recognition of precontribution gain.

(a) *Determination of gain—(1) In general.* A partner that receives a distribution of property (other than money) must recognize gain under section 737 and this section in an amount equal to the lesser of the excess distribution (as defined in paragraph (b) of this section) or the partner's net precontribution gain (as defined in

paragraph (c) of this section). Gain recognized under section 737 and this section is in addition to any gain recognized under section 731.

(2) *Transactions to which section 737 applies.* Section 737 and this section apply only to a distribution that is properly characterized as a distribution to a partner acting in the capacity of a partner within the meaning of section 731. Section 737 does not apply to a transaction or distribution that is subject to provisions other than sections 731(a) or 737 (for example, a transaction or distribution subject to sections 707(a), 736(a), or 751(b)).

(b) *Excess distribution—(1) Definition.* The excess distribution is the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in the partner's partnership interest.

(2) *Fair market value of property.* The fair market value of the distributed property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(3) *Distributee partner's adjusted tax basis—(i) General rule.* In determining the amount of the excess distribution, the distributee partner's adjusted tax basis in the partnership interest includes any basis adjustment resulting from the distribution that is subject to section 737 (for example, adjustments required under section 752) and from any other distribution or transaction that is part of the same plan or arrangement, except for—

(A) The increase required under section 737(c)(1) for the gain recognized by the partner under section 737; and

(B) The decrease required under section 733(2) for any property distributed to the partner other than property previously contributed to the partnership by the distributee partner. See § 1.704-4(e)(1) for a rule in the context of section 704(c)(1)(B). See also § 1.737-3(b)(2) for a special rule for determining a partner's adjusted tax basis in distributed property previously contributed by the partner to the partnership.

(ii) *Advances or drawings.* The distributee partner's adjusted tax basis in the partnership interest is determined

as of the last day of the partnership's taxable year if the distribution to which section 737 applies is properly characterized as an advance or drawing against the partner's distributive share of income. See § 1.731-1(a)(1)(ii).

(c) *Net precontribution gain—(1) General rule.* The distributee partner's net precontribution gain is the net gain (if any) that the partner would have recognized under section 704(c)(1)(B) and § 1.704-4 if, at the time of the distribution to which section 737 applies, the partnership had actually distributed to another partner all section 704(c) property contributed to the partnership by the distributee partner. See § 1.704-4 for provisions determining a contributing partner's gain or loss under section 704(c)(1)(B) on an actual distribution of contributed section 704(c) property to another partner.

(2) *Special rules—(i) Property contributed on or before October 3, 1989.* Property contributed to the partnership on or before October 3, 1989, is not taken into account in determining a partner's net precontribution gain. See § 1.704-4(c)(1) for a similar rule in the context of section 704(c)(1)(B).

(ii) *Section 734(b)(1)(A) adjustments.* For distributions to a distributee partner of money by a partnership with a section 754 election in effect that are part of the same plan or arrangement as the distribution of property subject to section 737, for purposes of paragraph (a) and (c)(1) of this section the distributee partner's net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). See § 1.737-3(c)(4) for rules regarding basis adjustments for partnerships with a section 754 election in effect.

(iii) *Transfers of a partnership interest.* The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred. See § 1.704-3(a)(7) and § 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

(iv) *Section 704(c)(1)(B) gain recognized in related distribution.* A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704-4(d)(3)) on an actual distribution to another partner of

section 704(c) property contributed by the distributee partner that is part of the same plan or arrangement as the distribution to the distributee partner.

(v) *Section 704(c)(2) disregarded.* A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704-4(d)(2) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

(d) *Character of gain.* The character of the gain recognized by the distributee partner under section 737 and this section is determined by, and is proportionate to, the character of the partner's net precontribution gain. For this purpose, all gains and losses on section 704(c) property taken into account in determining the partner's net precontribution gain are netted according to their character. Any character with a net negative amount is disregarded. The character of the partner's gain under section 737 is the same as, and in proportion to, any character with a net positive amount. Character for this purpose is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and § 1.702-1(a).

(e) *Examples.* The following examples illustrate the provisions 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 737, and all partners are unrelated.

Example 1. Calculation of excess distribution and net precontribution gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable real property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$30,000. C contributes \$30,000 cash.

(ii) Property A has 10 years remaining on its cost recovery schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items under section 704(c) described in § 1.704-3(b)(1) for Property A. The partnership has book depreciation of \$3,000 per year (10 percent of the \$30,000 book basis in Property A) 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 also has tax depreciation of \$2,000 per year (10 percent of the \$20,000 adjusted tax basis in Property A). This \$2,000 tax depreciation is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of 1997, the book value of Property A is \$21,000 (\$30,000 initial book value less \$9,000 aggregate book depreciation) and its adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation).

(iv) On December 31, 1997, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is \$20,000. The amount of the excess distribution is \$10,000, the difference between the fair market value of the distributed Property B (\$30,000) and A's adjusted tax basis in A's partnership interest (\$20,000). A's net precontribution gain is \$7,000, the difference between the book value of Property A (\$21,000) and its adjusted tax basis at the time of the distribution (\$14,000). A recognizes gain of \$7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Determination of distributee partner's basis. (i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. B and C each contribute \$10,000 cash.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of \$9,000, subject to a \$9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under section 752, increasing A's adjusted tax basis in A's partnership interest from \$4,000 to \$7,000.

(iii) On December 31, 1998, A receives \$2,000 cash and Property B, subject to the \$9,000 liability, in partial liquidation of A's interest in the partnership.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A's partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A's adjusted tax basis is therefore increased to \$11,000 for this purpose (\$7,000 initial adjusted tax basis, less \$2,000 distribution of money, less \$3,000 (decrease in A's share of the \$9,000 partnership liability), plus \$9,000 (increase in A's individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A's partnership interest (\$11,000) is greater than the fair market value of the distributed property (\$9,000) and therefore, there is no excess distribution. A recognizes no gain under section 737.

Example 3. Net precontribution gain reduced for gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Properties A1 and A2, nondepreciable real properties each with a fair market value of \$10,000 and an adjusted tax basis of \$6,000. B contributes Property B,

nondepreciable real property, with a fair market value and adjusted tax basis of \$20,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest and, as part of the same distribution, Property A1 is distributed to B in partial liquidation of B's interest in the partnership.

(iii) A's net precontribution gain before the distribution is \$8,000 (\$20,000 fair market value of Properties A1 and A2 less \$12,000 adjusted tax basis of such properties). A recognizes \$4,000 of gain under section 704(c)(1)(B) and § 1.704-4 on the distribution of Property A1 to B (\$10,000 fair market value of Property A1 less \$6,000 adjusted tax basis of Property A1). This gain is taken into account in determining A's excess distribution and net precontribution gain. As a result, A's net precontribution gain is reduced from \$8,000 to \$4,000, and the adjusted tax basis in A's partnership interest is increased by \$4,000 to \$16,000.

(iv) A recognizes gain of \$4,000 on the receipt of Property B under section 737, an amount equal to the excess distribution of \$4,000 (\$20,000 fair market value of Property B less \$16,000 adjusted tax basis of A's interest in the partnership) and A's remaining net precontribution gain of \$4,000.

Example 4. Character of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$30,000	\$20,000
Property A2	30,000	38,000
Property A3	10,000	9,000

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$70,000. C contributes \$70,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$3,000 of gain under section 737, an amount equal to the excess distribution of \$3,000 (\$70,000 fair market value of Property B less \$67,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$3,000 (\$70,000 aggregate fair market value of properties contributed by A less \$67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A's gain, all gains and losses on property taken into account in determining A's net precontribution gain are netted according to their character and allocated to A's recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains into account separately under section 702. As a result, A's net precontribution gain of

\$3,000 consists of \$2,000 of net long-term, U.S.-source capital gain (\$10,000 gain on Property A1 and \$8,000 loss on Property A2) and \$1,000 of net long-term, foreign-source capital gain (\$1,000 gain on Property A3).

(v) The character of A's gain under paragraph (d) of this section is therefore \$2,000 long-term, U.S.-source capital gain (\$3,000 gain recognized under section 737×\$2,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain) and \$1,000 long-term, foreign-source capital gain (\$3,000 gain recognized under section 737×\$1,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain).

§ 1.737-2 Exceptions and special rules.

(a) *Section 708(b)(1)(B) terminations.* Section 737 and this section do not apply to a deemed distribution of property on a termination of the partnership under section 708(b)(1)(B). See § 1.704-4(c)(3) for a similar rule in the context of section 704(c)(1)(B).

(b) *Complete transfer to another partnership.* Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in complete liquidation of the transferor partnership as part of the same plan or arrangement. In addition, section 737 and this section do not apply to any transaction, such as a partnership merger under section 708(b)(2)(A), that is treated in a similar manner. A subsequent distribution of property by the transferee partnership to the partners of the transferee partnership who were formerly partners of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

(c) *Incorporation of a partnership.* Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is completely liquidated as part of the same plan or arrangement as the incorporation transaction.

(d) *Distribution of previously contributed property—(1) General rule.* Any portion of the distributed property that consists of property previously contributed by the distributee partner (including property treated as contributed by the partner in connection with a termination of the partnership

under section 708(b)(1)(B) (*previously contributed property*) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. See § 1.737-3(b)(2) for a special rule for determining the basis of previously contributed property in the hands of a distributee partner who contributed the property to the partnership.

(2) *Limitation for distribution of previously contributed interest in an entity.* An interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership. The preceding sentence does not apply to the extent that the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership.

(3) *Nonrecognition transactions.* Property received by the partnership in exchange for contributed section 704(c) property in a nonrecognition transaction is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the property received is treated as section 704(c) property under § 1.704-3(a)(8). See § 1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(e) *Examples.* The following examples illustrate the rules 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 737, and all partners are unrelated.

Example 1. Distribution of previously contributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$20,000	\$10,000
Property A2	10,000	6,000

(ii) A's total net precontribution gain on the contributed property is \$14,000 (\$10,000 on Property A1 plus \$4,000 on Property A2). B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. C contributes \$30,000 cash.

(iii) On December 31, 1998, Property A2 and Property B are distributed to A in

complete liquidation of A's interest in the partnership. Property A2 was previously contributed by A and is therefore not taken into account in determining the amount of the excess distribution or A's net precontribution gain. The adjusted tax basis of Property A2 in the hands of A is also determined under section 732 as if that property were the only property distributed to A.

(iv) As a result of excluding Property A2 from these determinations, the amount of the excess distribution is \$10,000 (\$20,000 fair market value of distributed Property B less \$10,000 adjusted tax basis in A's partnership interest). A's net precontribution gain is also \$10,000 (\$14,000 total net precontribution gain less \$4,000 gain with respect to previously contributed Property A2). A therefore recognizes \$10,000 of gain on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Distribution of a previously contributed interest in an entity. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000, and all of the stock of Corporation X with a fair market value and adjusted tax basis of \$500. B contributes \$500 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. Partner C contributes \$10,500 cash. On December 31, 1996, ABC contributes Property B to Corporation X in a nonrecognition transaction under section 351.

(ii) On December 31, 1998, all of the stock of Corporation X is distributed to A in complete liquidation of A's interest in the partnership. The stock is treated as previously contributed property with respect to A only to the extent of the \$500 fair market value of the Corporation X stock contributed by A. The fair market value of the distributed stock for purposes of determining the amount of the excess distribution is therefore \$10,000 (\$10,500 total fair market value of Corporation X stock less \$500 portion treated as previously contributed property). The \$500 fair market value and adjusted tax basis of the Corporation X stock is also not taken into account in determining the amount of the excess distribution and the net precontribution gain.

(iii) A recognizes \$5,000 of gain under section 737, the amount of the excess distribution (\$10,000 fair market value of distributed property less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis in Property A).

§ 1.737-3 Basis adjustments; Recovery rules.

(a) *Distributee partner's adjusted tax basis in the partnership interest.* The distributee partner's adjusted tax basis in the partnership interest is increased by the amount of gain recognized by the distributee partner under section 737 and this section. This increase is not

taken into account in determining the amount of gain recognized by the partner under section 737(a)(1) and this section or in determining the amount of gain recognized by the partner under section 731(a) on the distribution of money in the same distribution or any related distribution. See § 1.704-4(e)(1) for a determination of the distributee partner's adjusted tax basis in a distribution subject to section 704(c)(1)(B).

(b) *Distributee partner's adjusted tax basis in distributed property—(1) In general.* The distributee partner's adjusted tax basis in the distributed property is determined under section 732(a) or (b) as applicable. The increase in the distributee partner's adjusted tax basis in the partnership interest under paragraph (a) of this section is taken into account in determining the distributee partner's adjusted tax basis in the distributed property other than property previously contributed by the partner. See § 1.704-4(e)(2) for a determination of basis in a distribution subject to section 704(c)(1)(B).

(2) *Previously contributed property.* The distributee partner's adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to section 737 and § 1.737-1.

(c) *Partnership's adjusted tax basis in partnership property—(1) Increase in basis.* The partnership's adjusted tax basis in eligible property is increased by the amount of gain recognized by the distributee partner under section 737.

(2) *Eligible property.* Eligible property is property that—

(i) Entered into the calculation of the distributee partner's net precontribution gain;

(ii) Has an adjusted tax basis to the partnership less than the property's fair market value at the time of the distribution;

(iii) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(iv) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) and § 1.704-4 that was part of the same plan or arrangement as the distribution subject to section 737.

(3) *Method of adjustment.* For the purpose of allocating the basis increase under paragraph (c)(2) of this section among the eligible property, all eligible property of the same character is treated as a single group. Character for this

purpose is determined in the same manner as the character of the recognized gain is determined under § 1.737-1(d). The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under section 737. The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property's fair market value and its adjusted tax basis to the partnership at the time of the distribution. For property that has the same character and was contributed in the same (or a related) transaction, the basis increase is allocated based on the respective amounts of unrealized appreciation in such properties at the time of the distribution.

(4) *Section 754 adjustments.* The basis adjustment to partnership property made pursuant to paragraph (c)(1) of this section is not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including eligible property as defined in paragraph (c)(2) of this section) under section 734(b) pursuant to a section 754 election (other than basis adjustments under section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments to basis made under paragraph (a) and paragraph (c)(1) of this section. Basis adjustments under section 734(b)(1)(A) that are attributable to distributions of money to the distributee partner that are part of the same plan or arrangement as the distribution of property subject to section 737 are made before the adjustments to basis under paragraph (a) and paragraph (c)(1) of this section. See § 1.737-1(c)(2)(ii) for the effect, if any, of basis adjustments under section 734(b)(1)(A) on a partner's net precontribution gain. See also § 1.704-4(e)(3) for a similar rule regarding basis adjustments pursuant to a section 754 election in the context of section 704(c)(1)(B).

(d) *Recovery of increase to adjusted tax basis.* Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) *Examples.* The following examples illustrate the rules 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 737, and all partners are unrelated.

Example 1. Partner's basis in distributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$5,000 of gain under section 737, an amount equal to the excess distribution of \$5,000 (\$10,000 fair market value of Property B less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$5,000 (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the \$5,000 of gain recognized under section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is \$10,000 under section 732(b).

Example 2. Partner's basis in distributed property in connection with gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$10,000	\$5,000
Property A2	10,000	2,000

(ii) 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.

(iii) On December 31, 1998, Property B is distributed to A in partial liquidation of A's interest in the partnership and Property A1 is distributed to B in partial liquidation of B's interest in the partnership. A recognizes \$5,000 of gain under section 704(c)(1)(B) and § 1.704-4 on the distribution of Property A1 to B, the difference between the fair market value of such property (\$10,000) and the adjusted tax basis in distributed Property A1 (\$5,000). The adjusted tax basis of A's partnership interest is increased by this \$5,000 of gain under section 704(c)(1)(B) and § 1.704-4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the

excess distribution. As a result, there is no excess distribution because the fair market value of Property B (\$10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution (\$12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is \$10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from \$12,000 to \$2,000 under section 733. See Example 3 of § 1.737-1(e).

Example 3. Partnership's basis in partnership property after a distribution with section 737 gain. (i) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$1,000	\$500
Property A2	4,000	1,500
Property A3	4,000	6,000
Property A4	6,000	4,000

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$15,000. C contributes \$15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of \$3,000 under section 737, an amount equal to the excess distribution of \$3,000 (\$15,000 fair market value of Property B less \$12,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$3,000 (\$15,000 aggregate fair market value of the property contributed by A less \$12,000 aggregate adjusted tax basis of such property).

(iv) \$2,000 of A's gain is long-term, foreign-source capital gain (\$3,000 total gain under section 737×\$2,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain). \$1,000 of A's gain is long-term, U.S.-source capital gain (\$3,000 total gain under section 737×\$1,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by \$3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) \$2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because \$2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from \$4,000 to \$6,000. \$1,000 of the increase must be allocated to Properties A1 and A2 because \$1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax

basis. The \$1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by \$167 ($\$1,000 \times \$500 / \$3,000$) and the adjusted tax basis of Property A2 is increased by \$833 ($\$1,000 \times \$2,500 / 3,000$).

§ 1.737-4 Anti-abuse rule.

(a) *In general.* The rules of section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 must be applied in a manner consistent with the purpose of section 737.

Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See § 1.704-4(f) for an anti-abuse rule and examples in the context of section 704(c)(1)(B). The anti-abuse rule and examples under section 704(c)(1)(B) and § 1.704-4(f) are relevant to section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) *Examples.* The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. 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 737, and all partners are unrelated.

Example 1. Increase in distributee partner's basis by temporary contribution; results inconsistent with the purpose of section 737. (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 \$1,000. B contributes Property B, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A contributes to the partnership Property A2, nondepreciable real

property with a fair market value and adjusted tax basis of \$9,000. A, therefore, increased the adjusted tax basis of A's partnership interest from \$1,000 to \$10,000. The partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in partial liquidation of A's interest in the partnership. If the contribution of Property A2 is taken into account for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B (\$10,000) does not exceed the adjusted tax basis of A's interest in the partnership (\$10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is \$10,000 under section 732(a)(1) and the adjusted tax basis of A's partnership interest is reduced to zero under section 733.

(iii) On March 1, 2000, A receives Property A2 from the partnership in complete liquidation of A's interest in the partnership. A recognizes no gain on the distribution of Property A2 because the property was previously contributed property. See § 1.737-2(d).

(iv) Although the contribution of Property A2 increases the adjusted tax basis of A's interest in the partnership (assuming it was a valid contribution to the partnership under section 721), it would be inconsistent with the purpose of section 737 to recognize the contribution of Property A2 to the partnership as in substance a bona fide contribution of an asset used in the conduct of joint business activity. Section 737 requires recognition of gain when the value of distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. Section 737 assumes that any contribution or other transaction that affects a partner's adjusted tax basis in the partnership interest is not a transitory contribution or transaction engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the contribution of Property A2 was a transitory contribution made with a principal purpose of avoiding recognition of gain under section 737, the Commissioner can disregard the contribution of Property A2 for this purpose. As a result, A recognizes gain of \$9,000 under section 737 on the receipt of Property B, an amount equal to the lesser of the excess distribution of \$9,000 ($\$10,000$ fair market value of distributed Property B less the \$1,000 adjusted tax basis of A's partnership interest, determined without regard to the transitory contribution of Property A2) or A's net precontribution gain of \$9,000 on Property A1.

Example 2. Increase in distributee partner's basis; section 752 liability shift; results consistent with the purpose of section 737. (i) On January 1, 1995, A and B form general partnership AB as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. The partnership also borrows \$10,000 on a

recourse basis and purchases Property C. The \$10,000 liability is allocated equally between A and B under section 752, thereby increasing the adjusted tax basis in A's partnership interest to \$6,000.

(ii) On December 31, 1998, the partners agree that A is to receive Property B in partial liquidation of A's interest in the partnership. If A were to receive Property B at that time, A would recognize \$4,000 of gain under section 737, an amount equal to the lesser of the excess distribution of \$4,000 ($\$10,000$ fair market value of Property B less \$6,000 adjusted tax basis in A's partnership interest) or A's net precontribution gain of \$9,000 ($\$10,000$ fair market value of Property A less \$1,000 adjusted tax basis of Property A).

(iii) With a principal purpose of avoiding such gain, A and B agree that A will be solely liable for the repayment of the \$10,000 partnership liability and take the steps necessary so that the entire amount of the liability is allocated to A under section 752. The adjusted tax basis in A's partnership interest is thereby increased from \$6,000 to \$11,000 to reflect A's share of the \$5,000 of liability previously allocated to B. As a result of this increase in A's adjusted tax basis, there is no excess distribution because the fair market value of distributed Property B (\$10,000) is less than the adjusted tax basis of A's partnership interest. Recognizing A's increased adjusted tax basis as a result of the shift in liabilities is consistent with the purpose of section 737 and this section. Section 737 requires recognition of gain only when the value of the distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. The \$10,000 recourse liability is a bona fide liability of the partnership and A's and B's agreement that A will assume responsibility for repayment of that debt has substance. Therefore, the increase in A's adjusted tax basis in A's interest in the partnership due to the shift in partnership liabilities under section 752 is respected, and A recognizes no gain under section 737.

§ 1.737-5 Effective date.

Sections 1.737-1, 1.737-2, 1.737-3, and 1.737-4 apply to distributions by a partnership to a partner on or after January 9, 1995.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

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