

in certain contributions to which section 721(a) applies.

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DISTRIBUTIONS BY A PARTNERSHIP

**§ 1.731-1 Extent of recognition of gain or loss on distribution.**

(a) *Recognition of gain or loss to partner*—(1) *Recognition of gain.* (i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i.e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of \$10,000 receives a distribution of cash of \$8,000 and property with a fair market value of \$3,000, no gain is recognized to him. If \$11,000 cash were distributed, gain would be recognized to the extent of \$1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items). See section 731(c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) *Recognition of loss.* Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751(c)), and inventory items (as defined in section 751(d)(2)). The term *liquidation of a partner's inter-*

*est*, as defined in section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of:

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

*Example 1.* Partner A has a partnership interest in partnership ABC with an adjusted basis to him of \$10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is \$5,000 cash and inventory with a basis to him (under section 732) of \$3,000. Partner A realizes a capital loss of \$2,000, which is recognized under section 731(a)(2).

*Example 2.* Partner B has a partnership interest in partnership BCD with an adjusted basis to him of \$10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is \$4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of \$2,000, and unrealized receivables having a basis to him (under section 732) of \$3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is \$3,000.

(3) *Character of gain or loss.* Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) *Gain or loss recognized by partnership.* A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss

may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) *Exceptions.* (1) Section 731 does not apply to the extent otherwise provided by:

(i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest) and

(ii) Section 751 (relating to unrealized receivables and inventory items).

For example, payments under section 736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

**§ 1.731-2 Partnership distributions of marketable securities.**

(a) *Marketable securities treated as money.* Except as otherwise provided in section 731(c) and this section, for purposes of sections 731(a)(1) and 737, the term money includes marketable securities and such securities are taken

into account at their fair market value as of the date of the distribution.

(b) *Reduction of amount treated as money—(1) Aggregation of securities.* For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security.

(2) *Amount of reduction.* The amount of the distribution of marketable securities that is treated as a distribution of money under section 731(c) and paragraph (a) of this section is reduced (but not below zero) by the excess, if any, of—

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

(3) *Distributee partner's share of net gain.* For purposes of section 731(c)(3)(B) and paragraph (b)(2) of this section, a partner's distributive share of net gain is determined—

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;

(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c) and this section; and

(iii) Without taking into account any gain or loss attributable to a distributed security to which paragraph (d)(1) of this section applies.

(c) *Marketable securities—(1) In general.* For purposes of section 731(c) and this section, the term *marketable securities* is defined in section 731(c)(2).

(2) *Actively traded.* For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the

meaning of section 1092(d)(1). Thus, for example, if XYZ common stock is listed on a national securities exchange, particular shares of XYZ common stock that are distributed by a partnership are marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) *Interests in an entity*—(i) *Substantially all*. For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) *Less than substantially all*. For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) *Value of assets*. For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) *Exceptions*—(1) *In general*. Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was contributed to the partnership by the distributee partner;

(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied—

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of

the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied—

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) *Anti-stuffing rule*. Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) *Successor security*. Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and this section otherwise would have applied to the exchanged security.

(e) *Investment partnerships*—(1) *In general*. Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section

731(c)(3)(C)(i) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) *Eligible partner*—(i) *Contributed services*. For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) *Contributed partnership interests*. For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) *Trade or business activities*. For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of—

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) *Partnership tiers*. For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

(f) *Basis rules*—(1) *Partner's basis*—(i) *Partner's basis in distributed securities*. The distributee partner's basis in distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) *Partner's basis in partnership interest*. The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) *Basis of partnership property*. No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) *Coordination with other sections*—(1) *Sections 704(c)(1)(B) and 737*—(i) *In general*. If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) *Section 704(c)(1)(B)*. The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) *Section 737—(A) Marketable securities as other property*. A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner's net precontribution gain under section 737(b).

(B) *Basis increase under section 737*. The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner's basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) *Section 708(b)(1)(B)*. If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) *Anti-abuse rule*. The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h)—

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) *Examples*. The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to

section 731(c). The examples are as follows:

*Example 1. Recognition of gain.* (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes property with a fair market value of \$1,000 and an adjusted tax basis of \$250. *B* contributes \$1,000 cash. *AB* subsequently purchases Security *X* for \$500 and immediately distributes the security to *A* in a current distribution. The basis in *A*'s interest in the partnership at the time of distribution is \$250.

(ii) The distribution of Security *X* is treated as a distribution of money in an amount equal to the fair market value of Security *X* on the date of distribution (\$500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security *X* had been sold immediately before the distribution, there would have been no gain recognized by *AB* and *A*'s distributive share of the gain would therefore have been zero.) As a result, *A* recognizes \$250 of gain under section 731(a)(1) on the distribution (\$500 distribution of money less \$250 adjusted tax basis in *A*'s partnership interest).

*Example 2. Reduction in amount treated as money—in general.* (i) *A* and *B* form partnership *AB* as equal partners. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X .....	100	70	30
Security Y .....	100	80	20
Security Z .....	100	110	(10)

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized \$40 of net gain (\$30 gain on Security *X* plus \$20 gain on Security *Y* minus \$10 loss on Security *Z*). *A*'s distributive share of this gain would have been \$20 (one-half of \$40 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have \$10 of net gain (\$20 of gain on Security *Y* minus \$10 loss on Security *Z*). *A*'s distributive share of this gain would have been \$5 (one-half of \$10 net gain). As a result, the distribution resulted in a decrease of \$15 in *A*'s distributive share of the net gain in *AB*'s securities (\$20 net gain before distribution minus \$5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by \$15. The distribution of Security *X* is therefore treated as a distribution of \$85

of money to *A* (\$100 fair market value of Security *X* minus \$15 reduction).

*Example 3. Reduction in amount treated as money—carried interest.* (i) *A* and *B* form partnership *AB*. *A* contributes \$1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. *B* contributes \$1,000 in exchange for a 40 percent interest in partnership profits. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

	Value	Basis	Gain
Security X .....	100	80	20
Security Y .....	100	90	10

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized \$30 of net gain (\$20 gain on Security *X* plus \$10 gain on Security *Y*). *A*'s distributive share of this gain would have been \$18 (60 percent of \$30 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have \$10 of net gain (\$10 gain on Security *Y*). *A*'s distributive share of this gain would have been \$6 (60 percent of \$10 net gain). As a result, the distribution resulted in a decrease of \$12 in *A*'s distributive share of the net gain in *AB*'s securities (\$18 net gain before distribution minus \$6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by \$12. The distribution of Security *X* is therefore treated as a distribution of \$88 of money to *A* (\$100 fair market value of Security *X* minus \$12 reduction).

*Example 4. Reduction in amount treated as money—change in partnership allocations.* (i) *A* is admitted to partnership *ABC* as a partner with a 1 percent interest in partnership profits. At the time of *A*'s admission, *ABC* held no securities. *ABC* subsequently acquires Security *X*. *A*'s interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. *A* retains a 1 percent interest in all securities acquired before the increase. *ABC* then acquires Securities *Y* and *Z* and later distributes Security *X* to *A* in a current distribution. Immediately before the distribution, the securities held by *ABC* had the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X .....	1,000	500	500
Security Y .....	1,000	800	200
Security Z .....	1,000	1,100	(100)

(ii) If *ABC* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized \$600 of net gain (\$500 gain on Security *X* plus \$200 gain on Security *Y* minus \$100 loss on Security *Z*). *A*'s distributive share of this gain would have been \$7 (1 percent of \$500 gain on Security *X* plus 2 percent of \$200 gain on Security *Y* minus 2 percent of \$100 loss on Security *Z*).

(iii) If *ABC* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have \$100 of net gain (\$200 gain on Security *Y* minus \$100 loss on Security *Z*). *A*'s distributive share of this gain would have been \$2 (2 percent of \$200 gain on Security *Y* minus 2 percent of \$100 loss on Security *Z*). As a result, the distribution resulted in a decrease of \$5 in *A*'s distributive share of the net gain in *ABC*'s securities (\$7 net gain before distribution minus \$2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by \$5. The distribution of Security *X* is therefore treated as a distribution of \$995 of money to *A* (\$1000 fair market value of Security *X* minus \$5 reduction).

*Example 5. Basis consequences—distribution of marketable security.* (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property with a fair market value and adjusted tax basis of \$100.

(ii) *AB* subsequently distributes Security *X* with a fair market value of \$120 and an adjusted tax basis of \$90 to *A* in a current distribution. At the time of distribution, the basis in *A*'s interest in the partnership is \$100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by \$15 (one-half of \$30 net gain in Security *X*). As a result, *A* recognizes \$5 of gain under section 731(a) on the distribution (excess of \$105 distribution of money over \$100 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is \$95 (\$90 adjusted basis of Security *X* determined under section 732(a)(1) plus \$5 of gain recognized by *A* by reason of section 731(c)). The basis in *A*'s interest in the partnership is \$10 as determined under section 733 (\$100 pre-distribution basis minus \$90 basis allocated to Security *X* under section 732).

*Example 6. Basis consequences—distribution of marketable security and other property.* (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property, with a fair market value of \$100 and an adjusted tax basis of \$10.

(ii) *AB* subsequently distributes Security *X* with a fair market value and adjusted tax basis of \$40 to *A* in a current distribution and, as part of the same distribution, *AB* dis-

tributes Property *Z* to *A* with an adjusted tax basis and fair market value of \$40. At the time of distribution, the basis in *A*'s interest in the partnership is \$10. *A* recognizes \$30 of gain under section 731(a) on the distribution (excess of \$40 distribution of money over \$10 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is \$35 (\$5 adjusted basis determined under section 732(a)(2) plus \$30 of gain recognized by *A* by reason of section 731(c)). *A*'s basis in Property *Z* is \$5, as determined under section 732(a)(2). The basis in *A*'s interest in the partnership is \$0 as determined under section 733 (\$10 pre-distribution basis minus \$10 basis allocated between Security *X* and Property *Z* under section 732).

(iv) *AB*'s adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If *AB* made such an election, the aggregate basis of *AB*'s assets would be increased by \$70 (the difference between the \$80 combined basis of Security *X* and Property *Z* in the hands of the partnership before the distribution and the \$10 combined basis of the distributed property in the hands of *A* under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by *A* by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of *A* by reason of section 731(c).

*Example 7. Coordination with section 737.* (i) *A* and *B* form partnership *AB*. *A* contributes Property *A*, nondepreciable real property with a fair market value of \$200 and an adjusted basis of \$100 in exchange for a 25 percent interest in partnership capital and profits. *AB* owns marketable Security *X*.

(ii) Within five years of the contribution of Property *A*, *AB* subsequently distributes Security *X*, with a fair market value of \$120 and an adjusted tax basis of \$100, to *A* in a current distribution that is subject to section 737. As part of the same distribution, *AB* distributes Property *Y* to *A* with a fair market value of \$20 and an adjusted tax basis of \$0. At the time of distribution, there has been no change in the fair market value of Property *A* or the adjusted tax basis in *A*'s interest in the partnership.

(iii) If *AB* had sold Security *X* for fair market value immediately before the distribution to *A*, the partnership would have recognized \$20 of gain. *A*'s distributive share of this gain would have been \$5 (25 percent of \$20 gain). Because *AB* has no other marketable securities, *A*'s distributive share of gain in partnership securities after the distribution would have been \$0. As a result, the distribution resulted in a decrease of \$5 in *A*'s share of the net gain in *AB*'s securities (\$5 net gain before distribution minus \$0 net

gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$5. The distribution of Security X is therefore treated as a distribution of \$115 of money to A (\$120 fair market value of Security X minus \$5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money (\$5) is treated as other property for purposes of section 737.

(iv) A recognizes total gain of \$40 on the distribution. A recognizes \$15 of gain under section 731(a)(1) on the distribution of the portion of Security X treated as money (\$115 distribution of money less \$100 adjusted tax basis in A's partnership interest). A recognizes \$25 of gain under section 737 on the distribution of Property Y and the portion of Security X that is not treated as money. A's section 737 gain is equal to the lesser of (i) A's precontribution gain (\$100) or (ii) the excess of the fair market value of property received (\$20 fair market value of Property Y plus \$5 portion of Security X not treated as money) over the adjusted basis in A's interest in the partnership immediately before the distribution (\$100) reduced (but not below zero) by the amount of money received in the distribution (\$115).

(v) A's adjusted tax basis in Security X is \$115 (\$100 basis of Security X determined under section 732(a) plus \$15 of gain recognized by reason of section 731(c)). A's adjusted tax basis in Property Y is \$0 under section 732(a). The basis in A's interest in the partnership is \$25 (\$100 basis before distribution minus \$100 basis allocated to Security X under section 732(a) plus \$25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

[T.D. 8707, 61 FR 67938, Dec. 26, 1996; 62 FR 8086, Feb. 21, 1997]

**§ 1.732-1 Basis of distributed property other than money.**

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of

any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* Partner A, with an adjusted basis of \$15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of \$10,000 to the partnership immediately before distribution, and \$2,000 cash. The basis of the property in A's hands will be \$10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to \$3,000 (\$15,000 less \$2,000 cash, less \$10,000, the basis of the distributed property to A).

*Example 2.* Partner R has an adjusted basis of \$10,000 for his partnership interest. He receives a current distribution of \$4,000 cash and property with an adjusted basis to the partnership of \$8,000. The basis of the distributed property to partner R is limited to \$6,000 (\$10,000, the adjusted basis of his interest, reduced by \$4,000, the cash distributed).

(b) *Distribution in liquidation.* Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

*Example.* Partner B, with a partnership interest having an adjusted basis to him of \$12,000, retires from the partnership and receives cash of \$2,000, and real property with an adjusted basis to the partnership of \$6,000 and a fair market value of \$14,000. The basis of the real property to B is \$10,000 (B's basis for his partnership interest, \$12,000, reduced by \$2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner—(1) General rule—(i) Unrealized receivables and inventory items.* The basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and



inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in paragraph (c)(2)(i) of this section. See § 1.460-4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting.

(ii) *Other distributed property.* Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in paragraph (c)(2) of this section.

(2) *Adjustment to basis allocation*—(i) *Decrease in basis.* Any decrease to the basis of distributed property required under paragraph (c)(1) of this section is allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation before any decrease (but only to the extent of each property's unrealized depreciation). If the required decrease exceeds the amount of unrealized depreciation in the distributed property, the excess is allocated to the distributed property in proportion to the adjusted bases of the distributed property, as adjusted pursuant to the immediately preceding sentence.

(ii) *Increase in basis.* Any increase to the basis of distributed property required under paragraph (c)(1)(ii) of this section is allocated first to distributed property (other than unrealized receivables and inventory items) with unrealized appreciation in proportion to each property's respective amount of unrealized appreciation before any increase (but only to the extent of each property's unrealized appreciation). If the required increase exceeds the amount of unrealized appreciation in the dis-

tributed property, the excess is allocated to the distributed property (other than unrealized receivables or inventory items) in proportion to the fair market value of the distributed property.

(3) *Unrealized receivables and inventory items.* If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of the partnership interest.

(4) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

*Example 1.* A is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of \$650. PRS distributes inventory items and Assets X and Y to A in liquidation of A's entire partnership interest. The distributed inventory items have a basis to the partnership of \$100 and a fair market value of \$200. Asset X has an adjusted basis to the partnership of \$50 and a fair market value of \$400. Asset Y has an adjusted basis to the partnership and a fair market value of \$100. Neither Asset X nor Asset Y consists of inventory items or unrealized receivables. Under this paragraph (c), A's basis in its partnership interest is allocated first to the inventory items in an amount equal to their adjusted basis to the partnership. A, therefore, has an adjusted basis in the inventory items of \$100. The remaining basis, \$550, is allocated to the distributed property first in an amount equal to the property's adjusted basis to the partnership. Thus, Asset X is allocated \$50 and Asset Y is allocated \$100. Asset X is then allocated \$350, the amount of unrealized appreciation in Asset X. Finally, the remaining basis, \$50, is allocated to Assets X and Y in proportion to their fair market values: \$40 to Asset X ( $400/500 \times \$50$ ), and \$10 to Asset Y ( $100/500 \times \$50$ ). Therefore, after the distribution, A has an adjusted basis of \$440 in Asset X and \$110 in Asset Y.

*Example 2.* B is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of \$200. PRS distributes Asset X and Asset Y to B in liquidation of its entire partnership interest. Asset X has an adjusted basis to the partnership and fair market value of \$150. Asset Y has an adjusted basis to the partnership of \$150 and a

fair market value of \$50. Neither of the assets consists of inventory items or unrealized receivables. Under this paragraph (c), B's basis is first assigned to the distributed property to the extent of the partnership's basis in each distributed property. Thus, Asset X and Asset Y are each assigned \$150. Because the aggregate adjusted basis of the distributed property, \$300, exceeds the basis to be allocated, \$200, a decrease of \$100 in the basis of the distributed property is required. Assets X and Y have unrealized depreciation of zero and \$100, respectively. Thus, the entire decrease is allocated to Asset Y. After the distribution, B has an adjusted basis of \$150 in Asset X and \$50 in Asset Y.

*Example 3.* C, a partner in partnership PRS, receives a distribution in liquidation of its entire partnership interest of \$6,000 cash, inventory items having an adjusted basis to the partnership of \$6,000, and real property having an adjusted basis to the partnership of \$4,000. C's basis in its partnership interest is \$9,000. The cash distribution reduces C's basis to \$3,000, which is allocated entirely to the inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

*Example 4.* Assume the same facts as in *Example 3* of this paragraph except C receives a distribution in liquidation of its entire partnership interest of \$1,000 cash and inventory items having a basis to the partnership of \$6,000. The cash distribution reduces C's basis to \$8,000, which can be allocated only to the extent of \$6,000 to the inventory items. The remaining \$2,000 basis, not allocable to the distributed property, constitutes a capital loss to partner C under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(5) *Effective date.* This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(d) *Special partnership basis to transferee under section 732(d).* (1)(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to

basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and §§ 1.743-1 and 1.732-2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the partnership. (For a shift of transferee's basis adjustment under section 743(b) to like property, see § 1.743-1(g).)

(vi) The provisions of this paragraph (d)(1) may be illustrated by the following example:

*Example.* (i) Transferee partner, T, purchased a one-fourth interest in partnership PRS for \$17,000. At the time T purchased the partnership interest, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of

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\$14,000 and a fair market value of \$16,000. T's purchase price reflected \$500 of this difference. Thus, \$4,000 of the \$17,000 paid by T for the partnership interest was attributable to T's share of partnership inventory with a basis of \$3,500. Within 2 years after T acquired the partnership interest, T retired from the partnership and received in liquidation of its entire partnership interest the following property:

	Assets	
	Adjusted basis to PRS	Fair market value
Cash .....	\$1,500	\$1,500
Inventory .....	3,500	4,000
Asset X .....	2,000	4,000
Asset Y .....	4,000	5,000

(ii) The fair market value of the inventory received by T was one-fourth of the fair market value of all partnership inventory and was T's share of such property. It is immaterial whether the inventory T received was on hand when T acquired the interest. In accordance with T's election under section 732(d), the amount of T's share of partnership basis that is attributable to partnership inventory is increased by \$500 (one-fourth of the \$2,000 difference between the fair market value of the property, \$16,000, and its \$14,000 basis to the partnership at the time T purchased its interest). This adjustment under section 732(d) applies only for purposes of distributions to T, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by T in the liquidating distribution is \$15,500 (\$17,000, T's basis for the partnership interest, reduced by the amount of cash received, \$1,500). This amount is allocated as follows: the basis of the inventory items received is \$4,000, consisting of the \$3,500 common partnership basis, plus the basis adjustment of \$500 which T would have had under section 743(b). The remaining basis of \$11,500 (\$15,500 minus \$4,000) is allocated among the remaining property distributed to T by assigning to each property the adjusted basis to the partnership of such property and adjusting that basis by any required increase or decrease. Thus, the adjusted basis to T of Asset X is \$5,111 (\$2,000, the adjusted basis of Asset X to the partnership, plus \$2,000, the amount of unrealized appreciation in Asset X, plus \$1,111 (\$4,000/\$9,000 multiplied by \$2,500)). Similarly, the adjusted basis of Asset Y to T is \$6,389 (\$4,000, the adjusted basis of Asset Y to the partnership, plus \$1,000, the amount of unrealized appreciation in Asset Y, plus, \$1,389 (\$5,000/\$9,000 multiplied by \$2,500)).

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return:

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest:

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

(5) *Required statements.* If a transferee partner notifies a partnership that it plans to make the election under section 732(d) under paragraph (d)(3) of this section, or if a partnership makes a distribution to which paragraph (d)(4) of this section applies, the partnership must provide the transferee with such

information as is necessary for the transferee properly to compute the transferee's basis adjustments under section 732(d).

(e) *Exception.* When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection(d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of § 1.751-1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69907, Dec. 15, 1999; T.D. 9137, 69 FR 42558, July 16, 2004]

**§ 1.732-2 Special partnership basis of distributed property.**

(a) *Adjustments under section 734(b).* In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section 743(b).* In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

*Example.* Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of \$1,000 and with respect to D it has a special basis adjustment of \$500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is \$1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only \$1,000. In such case, D's \$500 special basis adjustment may shift over to other property. See § 1.743-1(g).

(c) *Adjustments to basis of distributed inventory and unrealized receivables.* Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire

amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

*Example.* Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743(b). C retires from the partnership when the adjusted basis of his partnership interest is \$3,000. He receives from the partnership in liquidation of his entire interest, \$1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of \$800 with respect to partnership inventory items and of \$200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is \$500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40 percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be \$1,300 for the inventory items (\$500 plus \$800) and \$200 for the unrealized receivables (zero plus \$200). The remaining basis of \$500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: \$3,000 (total basis) less \$1,000 cash, or \$2,000 (the amount to be allocated to the basis of all distributed property), less \$1,500 (\$800 and \$200 special basis adjustments, plus \$500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (i. e., only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of \$800 for partnership inventory items and \$200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be \$650 (\$250,

the common partnership basis for inventory items distributed to him, plus \$400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be \$100 (zero plus \$100, one-half of C's special basis adjustment for unrealized receivables).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69908, Dec. 15, 1999]

**§ 1.732-3 Corresponding adjustment to basis of assets of a distributed corporation controlled by a corporate partner.**

The determination of whether a corporate partner has control of a distributed corporation for purposes of section 732(f) shall be made by applying the special aggregate stock ownership rules of § 1.1502-34.

[T.D. 8949, 66 FR 32902, June 19, 2001]

**§ 1.733-1 Basis of distributee partner's interest.**

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the amount of the basis to him of distributed property other than money as determined under section 732 and §§ 1.732-1 and 1.732-2.

**§ 1.734-1 Optional adjustment to basis of undistributed partnership property.**

(a) *General rule.* A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner, unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect.

(b) *Method of adjustment—(1) Increase in basis.* Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by:

(i) The amount of any gain recognized under section 731(a)(1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743(b) or section 732(d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

See § 1.460-4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting. The provisions of this paragraph (b)(1) are illustrated by the following examples:

*Example 1.* Partner A has a basis of \$10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of \$11,000 and property with a partnership basis of \$19,000 and a value of \$22,000. A receives \$11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of \$1,000 under section 731(a)(1). If the election under section 754 is in effect, the partnership basis for the property becomes \$20,000 (\$19,000 plus \$1,000).

*Example 2.* Partner D has a basis of \$10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

ASSETS		
	Adjusted basis	Value
Cash .....	\$4,000	\$4,000
Property X .....	11,000	11,000
Property Y .....	15,000	18,000
Total .....	30,000	33,000

LIABILITIES AND CAPITAL		
	Adjusted basis	Value
Liabilities .....	\$0	\$0
Capital:		
D .....	10,000	11,000
E .....	10,000	11,000
F .....	10,000	11,000
Total .....	30,000	33,000

In liquidation of his entire interest in the partnership, D received property X with a partnership basis of \$11,000. D's basis for property X is \$10,000 under section 732(b). Where the election under section 754 is in effect, the excess of \$1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes \$16,000 (\$15,000 plus \$1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734-2.

(2) *Decrease in basis.* Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by:

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

The provisions of this subparagraph may be illustrated by the following examples:

*Example 1.* Partner G has a basis of \$11,000 for his one-third interest in partnership GHI. Partnership assets consist of cash of \$10,000 and property with a basis of \$23,000 and a value of \$20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives \$10,000 in cash. He has a loss of \$1,000 under section 731(a)(2). If the election under section 754 is in effect, the partnership basis for the property becomes \$22,000 (\$23,000 less \$1,000).

*Example 2.* Partner J has a basis of \$11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:

ASSETS		
	Adjusted basis	Value
Cash .....	\$5,000	\$5,000
Property X .....	10,000	10,000
Property Y .....	18,000	15,000
Total .....	33,000	30,000

LIABILITIES AND CAPITAL		
	Adjusted basis	Value
Liabilities .....	\$0	\$0
Capital:		
J .....	11,000	10,000
K .....	11,000	10,000
L .....	11,000	10,000
Total .....	33,000	30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of \$10,000. J's basis for property X under section 732(b) is \$11,000.

Where the election under section 754 is in effect, the excess of \$1,000 (\$11,000 basis of property X to J, the distributee, less its \$10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes \$17,000 (\$18,000 less \$1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734-2.

(c) *Allocation of basis.* For allocation among the partnership properties of basis adjustments under section 734(b) and paragraph (b) of this section, see section 755 and § 1.755-1.

(d) *Returns.* A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(e) *Recovery of adjustments to basis of partnership property—(1) Increases in basis.* For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(2) *Decreases in basis.* For purposes of section 168, if the basis of a partnership's recovery property is decreased as a result of the distribution of property to a partner, then the decrease in basis must be accounted for over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.

(3) *Effective date.* This paragraph (e) applies to distributions of property from a partnership that occur on or after December 15, 1999.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69908, Dec. 15, 1999; T.D. 9137, 69 FR 42559, July 16, 2004]

### § 1.734-2 Adjustment after distribution to transferee partner.

(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see §§ 1.732-1 and 1.732-2.

(b)(1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

*Example.* Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of \$10,000 cash and land used in farming worth \$10,000 with a basis of \$1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of \$4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is \$10,000. S retires from the partnership and receives \$10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of \$4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to \$5,500.

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(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751(b) (relating to unrealized receivables and substantially appreciated inventory items). See section 751(b) and paragraph (b) of § 1.751-1.

### § 1.735-1 Character of gain or loss on disposition of distributed property.

(a) *Sale or exchange of distributed property*—(1) *Unrealized receivables*. Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in paragraph (c)(1) of § 1.751-1) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) *Inventory items*. Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751(d)(2)) received in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) *Holding period for distributed property*. A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership's holding period for contributed property, see § 1.723-1.

(c) *Effective date*. Section 735(a) applies to any property distributed by a

partnership to a partner after March 9, 1954. See section 771(b)(2) and paragraph (b)(2) of § 1.771-1. However, see section 771(c).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

### § 1.736-1 Payments to a retiring partner or a deceased partner's successor in interest.

(a) *Payments considered as distributive share or guaranteed payment*. (1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, chapter 1 of the Code, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to



partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b)(4)(ii) of §1.751-1. The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either:

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(5) The amount of any payments under section 736(a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed

payment. On the other hand, payments under section 736(b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b).

(b) *Payments for interest in partnership.* (1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (i.e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be

recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and paragraph (b) of § 1.751-1. The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the part-

nership has elected the optional basis adjustment under section 754. But see paragraph (b)(3)(iii) of § 1.751-1.

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows:

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736 (a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a) (1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of \$6,000 for 10 years for his interest in partnership property, receives only \$3,500 in 1955. In 1956, he receives \$10,000. Of this amount, \$8,500 (\$6,000 plus \$2,500 from 1955) is treated as a distribution under section 736 (b) for 1956; \$1,500, as a payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

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(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736 (a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or loss with respect to payments under section 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under section 731. However, where the total of section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any gain or loss by the difference between:

(i) The amount treated as a distribution under section 736(b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i.e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736(b) in that year bears to the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

(7) The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* Partnership ABC is a personal service partnership and its balance sheet is as follows:

ASSETS		
	Adjusted basis per books	Market value
Cash .....	\$13,000	\$13,000

**ASSETS—Continued**

	Adjusted basis per books	Market value
Unrealized receivables .....	0	30,000
Capital and section 1231 assets .....	20,000	23,000
<b>Total .....</b>	<b>33,000</b>	<b>66,000</b>

**LIABILITIES AND CAPITAL**

	Per books	Value
Liabilities .....	\$3,000	\$3,000
Capital:		
A .....	10,000	21,000
B .....	10,000	21,000
C .....	10,000	21,000
<b>Total .....</b>	<b>33,000</b>	<b>66,000</b>

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities (\$1,000) is assumed. In addition he is to receive \$9,000 in the year of retirement plus \$10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is \$30,000 (\$29,000 in cash and \$1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is \$12,000 (one-third of \$36,000, the sum of \$13,000 cash and \$23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is \$11,000 (\$10,000 plus \$1,000, his share of partnership liabilities), he will realize a capital gain of \$1,000 (\$12,000 minus \$11,000) from the disposition of his interest in partnership property. The remaining \$18,000 (\$30,000 minus \$12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is \$10,000, consisting of \$9,000 in cash, plus \$1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of \$10,000 will be allocated as follows: \$6,000 (18,000/30,000 of \$10,000) is a section 736(a)(2) payment and \$4,000 (12,000/30,000 of \$10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the \$6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only \$4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of \$1,000 when the last payment is made. However, if

A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each \$4,000 payment attributable to A's interest in partnership property, \$333 is capital gain (one-third of the total capital gain of \$1,000), and \$3,667 is a return of capital.

*Example 2.* Assume the same facts as in example 1 of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to \$12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of \$1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of \$12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

*Example 3.* Assume the same facts as in example 1 of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be \$9,000. The value of A's interest in partnership property described in section 736(b) is thus \$15,000 (one-third of \$45,000, the sum of \$13,000 cash, plus \$23,000, the value of capital and section 1231 assets, plus \$9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of \$4,000 (\$15,000, minus \$11,000 the basis of his interest). The remaining \$15,000 (\$30,000 minus \$15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

*Example 4.* Assume the same facts as in example 1 of this subparagraph except that the capital and section 1231 assets consist of an item of section 1245 property (as defined in section 1245(a)(3)). Assume further that under paragraph (c)(4) of § 1.751-1 the section 1245 property is an unrealized receivable to the extent of \$2,000. Therefore, the value of A's interest in section 736(b) partnership property is only \$11,333 (one-third of \$34,000, the sum of \$13,000 cash and \$21,000, the fair market value of section 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of \$333 (\$11,333 minus \$11,000, the basis of his interest). The remaining \$18,667 (\$30,000 minus \$11,333) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) *Cross reference.* See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

### § 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 the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731, except that section 737 and this section do not apply to the extent that section 751(b) applies to the distribution.

(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 distribution, 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 would have been recognized by the distributee partner under section 704(c)(1)(B) and § 1.704-4 if all property that had been contributed to the partnership by the distributee partner within five years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. 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 distribution 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 distribution 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)(3) 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. Character is determined at the partnership level for this purpose, and 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 contributes \$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 non-recourse 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 a current distribution.

(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 located in the United States each with a fair market value of \$10,000 and an adjusted tax basis of \$6,000. B contributes Property B, nondepreciable real property located outside the United States, 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 a current distribution.

(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 lesser of 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).

[T.D. 8642, 60 FR 66733, Dec. 26, 1995]

**§ 1.737-2 Exceptions and special rules.**

(a) *Section 708(b)(1)(B) terminations.* Section 737 and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner of the terminated partnership is subject to section 737 to the same extent that a distribution from the terminated partnership would have been subject to section 737. See also § 1.704-4(c)(3) for a similar rule in the context of section 704(c)(1)(B). This paragraph (a) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a) to the termination in a consistent manner.

(b) *Transfers to another partnership—*  
 (1) *Complete transfer.* 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 liquidation of the transferor partnership as part of the same plan or arrangement. See § 1.704-4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

(2) *Certain divisive transactions.* Section 737 and this section do not apply

to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership.

(3) *Subsequent distributions.* A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner 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 liquidated as part of the incorporation transaction. See §1.704-4(c)(5) for a similar rule in the context of section 704(c)(1)(B).

(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 (previously contributed property) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. The previous sentence applies on or after May 9, 1997. 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 in-

terest 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, installment sales, contributed contracts, and capitalized costs—(i) 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).

(ii) *Installment sales.* An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the installment obligation 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).

(iii) *Contributed contracts.* Property acquired by a partnership pursuant to a contract that is section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the acquired property 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).

(iv) *Capitalized costs.* Property to which the cost of section 704(c) property is properly capitalized is treated as section 704(c) property for purposes of section 737 to the extent that such property is treated as section 704(c) property under §1.704-3(a)(8)(iv). See §1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(4) *Undivided interests.* The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if



any, contributed by the distributee partner in the same property. See § 1.704-4(c)(6) for the application of section 704(c)(1)(B) in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(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 non-recognition 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).

*Example 3.* Distribution of undivided interest in property. (i) On January 1, 1995, A and B form partnership AB as equal partners. A contributes \$500 cash and an undivided one-half interest in Property X. B contributes \$500 cash and an undivided one-half interest in Property X.

(ii) On December 31, 1998, an undivided one-half interest in Property X is distributed to A in a current distribution. The distribution of the undivided one-half interest in Property X is treated as a distribution of previously contributed property because A contributed an undivided one-half interest in Property X. As a result, A does not recognize any gain under section 737 on the distribution.

[T.D. 8642, 60 FR 66735, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25501, May 9, 1997; T.D. 9193, 70 FR 14395, Mar. 22, 2005; T.D. 9207, 70 FR 30342, May 26, 2005; T.D. 9193, 70 FR 45531, Aug. 8, 2005]

**§ 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 distribution 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 adjustments to partnership property made pursuant to paragraph (c)(1) of this section are 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 distribution 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 located in the United States 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 located outside the United States, 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 a current distribution and Property A1 is distributed to B in a current distribution. 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  $\times$  \$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  $\times$  \$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).

[T.D. 8642, 60 FR 66736, Dec. 26, 1995; 61 FR 7214, Feb. 27, 1996]

#### § 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 trans-

action 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 transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from \$1,000 to \$10,000. On January 1, 1999, 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 a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership 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 A has treated the transfer of Property A2 as a contribution to the partnership that increased the adjusted tax basis of A's interest in the partnership, it would be inconsistent with the purpose of section 737 to recognize the transfer as a contribution to the partnership. 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 a contribution or transaction in substance and is not engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the transfer of Property A2 to the partnership was not a contribution in substance and was 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 a current distribution. 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 that was undertaken for a substantial business purpose 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.

[T.D. 8642, 60 FR 66738, Dec. 26, 1995]

#### § 1.737-5 Effective dates.

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, except that § 1.737-2(d)(3)(iv) applies to distributions by a partnership to a partner on or after June 24, 2003.

[T.D. 9207, 70 FR 30342, May 26, 2005]

#### TRANSFERS OF INTERESTS IN A PARTNERSHIP

#### § 1.741-1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the